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No.

In the Supreme Court of the United States

OCTOBER TERM, 1977

77-83

HENRY W. MEERS,

Petitioner,

vs.

SUNDSTRAND CORPORATION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Henry W. Meers hereby petitions that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Seventh Circuit entered on February 23, 1977.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit is reported officially at 553 F.2d 1033 and unofficially at [1976-1977] CCH Fed. Sec. L. Rep.

¶95,887 and is printed in the Appendix at page 72. The opinion of the United States District Court of the Northern District of Illinois, Eastern Division, is not reported and is printed in the Appendix at page 2.

JURISDICTION

The Seventh Circuit's judgment was entered on February 23, 1977. (App. 108.) Petitioner's timely petition for rehearing was denied on April 18, 1977. (App. 109.) The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

1. Is the Seventh Circuit's new standard for liability in a civil damage suit under Rule 10b-5 inconsistent with this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), since it imposes liability for omissions deemed "reckless", with intent determined by an "objective" standard, even though the defendant acted in good faith and without any actual intent to deceive, manipulate or defraud?

2. In a civil damage suit where liability is imposed, not for any intent to deceive, manipulate or defraud, but only for recklessness, is it a defense to liability that the plaintiff acted with equal or greater recklessness?

STATUTE AND RULE INVOLVED

The statute and rule involved in this case are §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5, 17 C.F.R. §240.10b-5, promulgated thereunder. The text of these provisions is reproduced in the Appendix at page 1.

STATEMENT OF THE CASE

This action was brought in 1969 by Sundstrand Corporation against Standard Kollsman Industries, Inc. ("SKI"), a publicly-owned corporation, John B. Huarisa, who was president, a director and a major shareholder of SKI, and Henry W. Meers, who was a partner in the investment banking firm of White, Weld & Co. and an outside director of SKI.* Sundstrand claimed that defendants violated §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 in connection with its acquisition of 223,190 shares of SKI stock.

At the first trial (non-jury), this suit was dismissed at the close of plaintiff's case. Sundstrand appealed and obtained a reversal on the ground that certain evidence had been excluded. 488 F.2d 807 (1973). At the second trial, the District Court entered judgment against all defendants, jointly and severally, in the amount of $4,434,786 plus interest. (App. 71.) The defendants appealed, and the Seventh Circuit affirmed the judgment of liability but reduced the award of damages to $334,785 plus interest. (App. 107-08.)

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* In 1972, SKI was merged into Sun Chemical Corporation and Sun Chemical was substituted as a defendant. Huarisa died in 1975, and the executors of his estate were substituted as defendants.

STATEMENT OF FACTS

Introduction

In the period from November, 1968 into January, 1969, SKI and Sundstrand were carrying on negotiations, in which Meers was peripherally involved, for a possible merger. In the midst of the negotiations, a block of SKI stock, upon which Huarisa had an option, became available. In early January, 1969, after Meers' role in the merger was completed, Huarisa sold his option to Sundstrand for $334,785 in a side deal with which Meers had no involvement.

The Seventh Circuit applied an "objective" test to conclude that Meers was "reckless" in failing to call Sundstrand before it purchased the option and advise that a dissident SKI director had raised questions in the middle of 1968 about certain SKI accounting policies, questions which Meers believed to be without merit and to have been resolved many months earlier. Meers was held to be personally liable for the $334,785 which Sundstrand paid to Huarisa, even though there was no finding that he had any intent to deceive or defraud Sundstrand or that he had not acted in good faith. The Seventh Circuit determined that a defendant is liable under Section 10(b) for omissions which the Court "objectively" determined to be "reckless", even if the defendant "subjectively" lacked any intent to deceive, manipulate or defraud.

The following is a brief statement of facts as found by the courts below.

The Aborted Sundstrand-SKI Merger Negotiations

In the mid to late 1960's, Sundstrand was an aggressive, acquisition-minded company, which regularly reviewed

possible acquisition candidates. Between late 1967 and October, 1968, Sundstrand considered the possibility of acquiring SKI on three separate occasions. The initiative for Sundstrand's interest came from its wholly-owned subsidiary, United Controls, which manufactured aircraft instruments as did Kollsman Instrument Corporation, one of SKI's subsidiaries. In the fall of 1968, an officer of United Controls discussed its interest in acquiring SKI with a White, Weld partner, who immediately reported the conversation to Meers.

Negotiations for the possible merger of Sundstrand and SKI began in November, 1968. Meers arranged an initial meeting between executives of the two companies,* but he did not attend that meeting or participate in the extensive negotiations that took place up to the afternoon of December 26, 1968. Those negotiations were conducted by officers of Sundstrand and Huarisa. On December 23, 1968, Sundstrand decided to make an offer to acquire SKI at a price equivalent to $32.75 per share for SKI stock. Sundstrand made that decision without consulting with or advising Meers. The $32.75 offer was presented to Huarisa at a meeting at Sundstrand's offices on the morning of December 26, 1968. Huarisa rejected the offer as being too low and asked the Sundstrand officials to negotiate the price with Meers. A meeting was immediately arranged for that afternoon.

Meers (acting for SKI) and the Sundstrand officials met during the afternoon of December 26.** Sundstrand reit-

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* In his telephone call to arrange the initial meeting, Meers told Sundstrand to get any information it wanted about SKI from SKI.

** This was the first contact Meers had had with Sundstrand since his telephone call in November to arrange the first meeting between the companies.

erated the $32.75 proposal and twice increased its offer. Meers consulted by telephone with Huarisa as to each offer, and, after rejecting the first two, Huarisa agreed to recommend Sundstrand's "final" proposal of $38.25 per share to SKI's board of directors.* The $38.25 proposal was merely a preliminary proposal subject to approval by the board of directors of each company, agreement by the parties upon a definitive contract, and a detailed survey to be made by Sundstrand of the facilities and books of SKI and its subsidiaries.

Between December 26 and January 20, 1969 (when Sundstand terminated merger discussions), Meers had only two contacts with Sundstrand: on December 27, Sundstrand delivered a letter setting forth the terms of its offer to Meers' office, and on January 2, Sundstrand's president called Meers to ask if Meers knew how news of the merger, which was still not public, had "leaked".** There was no substantive discussion about the potential merger on either occasion.

On January 7, 1969, Sundstrand commenced an exhaustive investigation of SKI's financial condition. Its survey was conducted by fifteen Sundstrand officials and consumed at least seven days. Meers was not consulted about the investigation, nor was he advised of its progress. On January 20, Sundstrand called off the merger discussions because its investigative team had concluded that the merger

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* The parties agreed that, if a merger were consummated, White, Weld & Co. would be paid a fee of $150,000 for investment banking services to be performed in connection with the merger.

** It ultimately developed that Sundstrand's officers began purchasing SKI stock for their own accounts in late December, 1968, before the public announcement on January 2, 1969 of the tentative proposal, at prices substantially below the $38.25 price.

would not be in Sundstrand's best interest.* One of the principal reasons that Sundstrand decided against the merger was its conclusion that SKI would be unable to amortize all of the $4,700,000 of preproduction costs which SKI was carrying on its books as assets.**

The Side Deal — Sundstrand's Acquisition of Huarisa's Option

Although the merger never took place, Meers was held liable for Sundstrand's losses in a "side deal" with which he had no connection.

On December 7, 1968, during the preliminary merger discussions between Sundstrand and SKI, Sun Chemical Corporation offered to purchase 223,190 shares of stock owned by the Burke family and upon which Huarisa had a right of first refusal at $30 per share. Sun Chemical's offer to buy the stock and Huarisa's option rights were widely reported in the Wall Street Journal and the Chicago papers. Meers assumed that Huarisa would exercise his option, and Huarisa, in fact, intended to do so.

But in early January, 1969, Huarisa was told by his lawyers that he would have securities law and tax prob-

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* The Sundstrand officers who had purchased SKI stock in December, 1968, before news of the merger negotiations was made public, sold their SKI stock, at a substantial profit, in mid-January, 1969 before news that the merger was off was made public.

** Before making its proposals in December, 1968, Sundstrand knew that SKI had substantial deferred preproduction costs. That fact was disclosed in SKI's 1967 annual report and was discussed by Huarisa at a meeting with Sundstrand officers in November, 1968. The magnitude of these deferred costs caused Sundstrand's president to personally instruct the survey team to investigate this matter thoroughly.

lems if he bought the Burke stock and then sold it to Sundstrand in the proposed merger. Therefore, on January 4, 1969, Huarisa called Sundstrand's president, advised him of the problem, and arranged a meeting for January 6, which Sundstrand's and SKI's counsel also attended. At this meeting, Sundstrand agreed to acquire Huarisa's option. On January 9, a written agreement providing for the acquisition of the option was executed by Sundstrand and Huarisa. The price was $334,785.* Thus, all discussions relating to Sundstand's acquisition of the option took place between January 4 and 9, with the only negotiating meeting being the one on January 6.

Meers did not know of the January 6 meeting or that Sundstrand was going to or might acquire the option until after the meeting had occurred. A few days after January 6, Huarisa or SKI's attorney called Meers and told him that Sundstrand had agreed to purchase the Burke stock. The earliest date upon which the call might have been made was January 8. Meers was not given any details of the transaction. He was not told that Sundstrand's agreement was still executory, or that the contract was to be signed the next day. Sundstrand made the decision to buy the option on January 6 and executed the agreement on January 9 without advising or consulting with Meers.

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* Under the option, the total purchase price for the 223,190 shares was $6,695,700. To exercise the option, a 5% initial payment ($334,785) was required. The remainder of the purchase price was to be made in two installments. After making the 5% payment, the option holder was not obligated to make any further payments. In agreeing to pay $334,785 for the option, Sundstrand was reimbursing Huarisa for the amount he had spent to exercise the option. Sundstrand, which had only acquired Huarisa's option to facilitate the proposed merger, bought the 223,190 shares on February 6, after it had terminated merger negotiations with SKI.

The Burke Report and Ernst & Ernst Letter

Both the District Court and the Seventh Circuit found Meers liable for failing to disclose a document referred to as the "Burke report" and a letter to Burke from an accountant at Ernst & Ernst.

James W. Burke, author of the Burke report, was a dissident member of SKI's board of directors and had been an officer of SKI. His father had been the founder of SKI. When his father died, Burke was passed over for the job of president, and Huarisa was brought in for that position. Huarisa demoted Burke for incompetence.

In mid-1968, after SKI's annual report for 1967 was released, Burke raised questions about the earnings reported therein. Burke expressed the opinion that those earnings were overstated, and he questioned a number of SKI's accounting practices, in particular, the practice of carrying preproduction costs as assets to be amortized over future contracts, rather than expensing those costs as they were incurred. Burke's questions were considered at a series of meetings held by the SKI board of directors and were rebutted by detailed written analyses prepared by SKI's management.

Then Burke employed an accountant from Ernst & Ernst, who did not conduct an audit but made only a brief review of some of SKI's financial data, and then wrote a letter posing questions similar to Burke's. At Meers' request, Price Waterhouse, the accountants who had certified SKI's 1967 financial statements, responded to the questions, and further meetings were held among the directors, the accountant from Ernst & Ernst, the accountants from Price Waterhouse, and SKI management. Price Waterhouse and SKI management firmly and consistently maintained that the company's accounting practices were proper in all respects and that the ques-

tions raised by Burke and the accountant from Ernst & Ernst were without substance.

Ultimately, in August, 1968, the Price Waterhouse partner in charge of the SKI account and SKI's financial vice-president met with a member of the staff of the Securities and Exchange Commission ("SEC") in Washington, D.C. and reviewed the various accounting questions. Meers had suggested such a meeting. The SEC did not find anything wrong with SKI's accounting, and in fact "concluded that the 1967 annual report [the report questioned by Burke] did not reflect improper accounting practices." (App. 96.) Meers was so advised.*

As a result of the consideration given to this matter in the summer of 1968, the SKI board decided that Burke's criticisms were without merit. Meers, who had attended a substantial number of the meetings, also concluded that Burke's objections were not valid, and that SKI's accounting practices were proper. In reaching that determination, Meers relied upon his analysis of the accounting questions from the meetings he had attended and the documents he had reviewed, the unequivocal positions taken and explanations given by management and Price Waterhouse, the fact that the questions posed by the accountant from Ernst & Ernst were admittedly raised without the benefit of a detailed examination of SKI's records, and the position taken by the SEC.

The Seventh Circuit held Meers liable solely for failing to disclose the Burke report and the Ernst & Ernst letter to Sundstrand prior to the purchase of Huarisa's option

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* Although the Seventh Circuit thought that "1968 accounting practices were not passed on in the SEC meeting" (App. 97), the SEC's acceptance of the practices employed in the 1967 annual report amounted to approval of the practices being employed by SKI's accountants in August, 1968, since the same accounting principles were being applied. That was what Burke was complaining about.

on January 9, 1969. Liability was imposed even though Meers testified that he had put this matter out of his mind after the August, 1968 meeting with the SEC was reported to him and he had decided that Burke was wrong. The basis for liability turns on the events of the January 2, 1969 SKI board meeting at which the Sundstrand merger proposal was considered. Burke testified that, at this meeting, he asked Huarisa whether Sundstrand had been advised of the questions he and the Ernst & Ernst accountant had raised. Burke further testified that Huarisa replied in the negative, and that SKI's attorney stated that those materials did not have to be given to Sundstrand.*

SKI's 1968 Earnings

In late January and February, 1969, as part of its regular audit for the year ended December 31, 1968, Price Waterhouse changed its position on some of the matters which had been discussed in mid-1968, and raised with SKI management some of the questions earlier raised by Burke. These questions were resolved in March, 1969 at meetings between Price Waterhouse and SKI financial people by having SKI write off substantial amounts of deferred preproduction costs which had previously been carried as assets. This resulted in reducing SKI's earnings from the 86 cents per share reported for the first three quarters of 1968 to a loss of 15 cents per share for the entire year.

In this period, Meers was not informed that Price Waterhouse had changed its approach to some of the questions considered in mid-1968, nor was he even aware that discus-

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* Meers testified that Burke did not raise any such question at the January 2 meeting. Huarisa, who had died prior to the trial, testified in full about the January 2 meeting at a deposition without mentioning any such discussion by Burke. Burke, who voted to approve the Sundstrand merger proposal, did not advise Sundstrand of his mid-1968 questions, nor did any other SKI director.

sions of this nature were taking place. He did not know that SKI would report a loss for 1968 until that fact was announced to the public at the end of March, 1969, almost three months after Sundstrand had purchased the option. He was surprised and immediately called SKI's financial vice-president for an explanation.

The Judgment Below

The Seventh Circuit held Meers personally liable for $334,785 for "reckless nondisclosure" because he did not call Sundstrand prior to January 9, 1969 and tell it about Burke's mid-1968 accounting objections.

The District Court found that SKI and Huarisa acted intentionally or recklessly to deceive Sundstrand, but premised Meers' liability solely upon negligence, making no finding that Meers had any intent to deceive or defraud Sundstrand, and making no finding that he had engaged in any intentional misconduct, or even that he had acted recklessly. Likewise, the Seventh Circuit did not find that Meers had any intent to deceive or defraud Sundstrand or that he lacked good faith. Instead, the Seventh Circuit applied an "objective" test and found Meers' conduct "reckless" as a matter of law.* The result was to find Meers liable for not advising Sundstrand of objections to accounting procedures which the Seventh Circuit in hindsight regarded as important, but which Meers in January, 1969, honestly and in good faith regarded as being without merit. According to the Seventh Circuit's new standard, Meers' lack of intent to defraud or deceive is irrelevant as a matter of law.

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* The only consideration given to Meers' actual or "subjective" state of mind by the Seventh Circuit was whether he had forgotten the Burke matter. Once the Seventh Circuit found that Meers had been reminded of Burke's objections at the January 2 board meeting, liability was "objectively" determined without regard to actual intent or good faith.

REASONS FOR GRANTING THE WRIT

I.

THE CULPABILITY STANDARD ADOPTED BY THE SEVENTH CIRCUIT CONFLICTS WITH A CONTROLLING DECISION OF THIS COURT.

This Court should grant certiorari in this case to reiterate the holding of *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), that Rule 10b-5 requires an intent to deceive, manipulate or defraud, and to reject the Seventh Circuit's new standard which imposes liability for negligence under the guise of an "objective" test of recklessness.

A. Ernst & Ernst Requires An Intent To Deceive, Manipulate Or Defraud.

In *Ernst & Ernst,* the Seventh Circuit held negligence sufficient for the imposition of liability under Rule 10b-5. 503 F.2d 1100 (7th Cir. 1974). This Court granted certiorari for the explicit purpose of deciding whether scienter —an intent to deceive, manipulate, or defraud—was necessary for liability or whether negligence was enough. The decision held squarely that scienter is required. 425 U.S. at 193 and 194 n.12.

In reaching its conclusion, the Court carefully examined the language and legislative history of §10(b) of the Securities Exchange Act of 1934 and the language and administrative history of Rule 10b-5. In all of these sources, it found that the focus was upon proscribing intentional, deceptive misconduct. Section 10(b) speaks of prohibiting "any manipulative or deceptive device or contriv-

ance", words which "strongly suggest that §10(b) was intended to proscribe knowing or intentional misconduct." 425 U.S. at 197. From the legislative history of §10(b), the Court concluded that "[t]here is no indication . . . that §10(b) was intended to proscribe conduct not involving scienter." 425 U.S. at 202. Similarly, Rule 10b-5 was promulgated to cover situations involving scienter and not something less than that. 425 U.S. at 212. Furthermore, the Court noted that "[t]here is no indication that Congress intended anyone to be made liable for [manipulative or deceptive] practices unless he acted other than in good faith." 425 U.S. at 206.

The Court recognized in a footnote that "[i]n certain areas of the law recklessness is considered to be *a form of intentional conduct* for purposes of imposing liability for some act", and left open the issue of whether reckless behavior could "in some circumstances" be a basis for liability under Rule 10b-5. 425 U.S. at 194, n.12. (Emphasis added.) But from the quoted language, it is obvious that recklessness can be a basis for Rule 10b-5 liability only where it is the equivalent of intentional misconduct, *i.e.*, an intent to deceive, manipulate or defraud.

The Seventh Circuit has seized upon the open issue of reckless conduct, 425 U.S. at 194 n.12, to fasten liability upon Meers. However, the Court did not require proof of bad faith or an intent to deceive, manipulate or defraud. Indeed, the District Court had distinguished between Meers and the other defendants by omitting any finding that Meers had engaged in intentional or reckless conduct. The Seventh Circuit admitted that a remand would be required if intent were critical.

However, the Seventh Circuit concluded that the conduct which the District Court had found to be negligent was "reckless" as a matter of law. Regardless of Meers'

good faith and lack of intent to defraud, the Seventh Circuit concluded that "recklessness" and liability are established solely by the Court's "objective" conclusion that the matters not disclosed to Sundstrand (*i.e.*, Burke's opinions about SKI's accounting) were very important in the transaction.

This Court in *Ernst & Ernst* squarely held that §10(b) liability requires lack of good faith and an intent to deceive, manipulate or defraud. The Seventh Circuit holds just as squarely that liability may be based on an "objective" determination of the materiality of the undisclosed matter—and that good faith and lack of an intent to defraud is no defense. It is difficult to imagine a more direct conflict with the standard enunciated by this Court. If *Ernst & Ernst* is not to be eroded, this Court must reject the new Seventh Circuit standard.

B. If Recklessness Can Ever Trigger Section 10(b) Liability, It Should Be Applied Only In Cases Involving Affirmative Misrepresentation — Not Nondisclosure Cases.

In the instant case, liability was not imposed for any affirmative misrepresentations by Meers, but rather for his failure to disclose. Liability should not be imposed for nondisclosure, as it was here, when there is no evidence of an intent to conceal, deceive or defraud. While the concept of "recklessness" may fit misrepresentation cases, it makes no sense as applied to nondisclosure.*

Recklessness can have independent meaning and may be a separate basis for liability for affirmative misrepresentations. Where a false representation is made, the

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* In its discussion of reckless conduct in footnote 12 of *Ernst & Ernst*, this Court spoke only of "reckless disregard for the truth." The opinion does not discuss recklessness in terms of omissions.

speaker may misstate intentionally, recklessly, or negligently. An intentional misrepresentation is one which the speaker knows to be false. A negligent misrepresentation has some basis but the basis is insufficient to make the representation reasonable. A reckless misrepresentation is one which the speaker has no factual basis for making—a statement made with such a flagrant disregard for the truth that the conduct may be deemed equivalent to an intent to deceive. In any event, it is clear that the speaker did not act in good faith. For example, if a seller of stock misstates the age of the company's manufacturing plant as 10 years rather than 25 years, he may act intentionally (knowing the correct age of the plant), recklessly (guessing the age "off the top of his head" without any effort to check the accuracy of his statement) or negligently (after making an unreasonably inadequate attempt to check the facts).

In contrast, there are not three degrees of conduct regarding omissions; there are no "reckless" omissions. If an omission does not occur for the purpose of defrauding or deceiving, the conduct is not equivalent to the intentional misconduct required by *Ernst & Ernst*. Anything less is a negligent omission, even if disguised by adjectives such as "recklessness" or "gross negligence". The Seventh Circuit's formulation that recklessness exists where the danger of misleading buyers through the omission was "so obvious that any reasonable man would be legally bound as knowing [the danger]" is merely another way of stating a "negligence" or "gross negligence" test. Absent a purpose to deceive or defraud, omissions which are labeled "reckless" are in reality only negligent and are not a proper basis for Rule 10b-5 liability. In omission

cases, the focus must be on whether there was a scheme or intent to deceive or defraud.*

The only "subjective" aspect of the Seventh Circuit's test is whether the defendant remembered the undisclosed facts. (App. 93, n.20.) If he remembered the facts, and the Court finds the facts to be material**, the Seventh Circuit will impose liability, regardless of his actual good faith and lack of purpose to defraud. Thus, even if the District Court had entered explicit findings (1) that Meers had no intent to deceive Sundstrand and (2) that Meers in good faith thought the Burke matter was unimportant and without merit, the Seventh Circuit would still find Meers liable. Clearly, this test is not equivalent to the *Ernst & Ernst* test, which requires intentional or wilful conduct to deceive, manipulate or defraud and which allows the defense of good faith. Instead, it is a negligence test dressed up with additional adjectives.

C. However Phrased, The Seventh Circuit Incorrectly Applied The Ernst & Ernst Test To The Facts Of This Case.

The manifest impropriety of the Seventh Circuit's test can be seen from its application to this case. On any of

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* Intentional wrongdoers will not be immunized for fraudulent failures to disclose by refusing to impose liability for "reckless" omissions. Mere denials of any bad faith will not preclude liability. It is common to infer an intent to deceive from circumstantial evidence of the defendant's conduct.

** Materiality, an objective test, is already in the Rule 10b-5 liability equation as an element separate and distinct from scienter, which focuses on the subjective mental state of the defendant. By making the culpability test depend upon materiality, the Seventh Circuit has, in effect, eliminated the scienter requirement.

the three key dates (December 26, January 2 and January 8), Meers' failure to advise Sundstrand of Burke's criticisms of SKI's accounting was at most negligence, and was never the result of any purpose to defraud or deceive Sundstrand.*

On December 26, 1968, Meers met with Sundstrand officials for a couple hours to negotiate the price of the proposed merger. The testimony is uncontroverted that, on that day, Meers had in fact forgotten about the Burke questions, which he thought had been resolved several months earlier when the SEC did not question SKI's accounting policies. Moreover, on December 26, the only transaction under consideration was Sundstrand's possible merger with SKI. Sundstrand had advised Meers that it was going to conduct a full scale, in-depth investigation of SKI before preparing a definitive agreement and proceeding with a merger, dealing directly with SKI to obtain desired information. Meers expected Sundstrand to do just that before it took any action, and

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* The court below incorrectly found (App. 88-89) that Meers was a "quasi-fiduciary" with an affirmative duty to disclose. The record is clear, based upon the events of late 1968 and January, 1969, that no such relationship or duty existed or was even contemplated by either Sundstrand or Meers. Throughout the merger negotiations, Sundstrand always looked to Huarisa and SKI for disclosure, never to Meers. It was clear that Meers was acting on behalf of SKI, not Sundstrand, in the very limited price negotiations which he carried on as a telephonic intermediary on December 26. At no time during the entire negotiations respecting the proposed merger did Sundstrand ever ask Meers for advice regarding either the merger or the purchase of the Burke option, nor did he give any advice. Sundstrand did not advise him in advance of its intentions to buy the Burke option. The only investment banking relationship which ever existed between Sundstrand and Meers' firm terminated in the spring of 1968, long before the merger negotiations with SKI began.

he never undertook a disclosure role, nor did Sundstrand expect him to. Sundstrand never consulted with him or requested information from him.

On January 2, at the SKI board meeting, Burke claims to have asked whether Sundstrand had been told of his questions, to which Huarisa said "no". Thus, the Seventh Circuit concluded that from January 2, Meers no longer had forgotten the Burke matter. Even if Meers' denial of that testimony is discounted, the evidence shows that Meers' failure to disclose was not due to bad faith or an intent to deceive. Burke testified that SKI's counsel advised the board (including Meers) that the Burke questions did not have to be disclosed to Sundstrand. The only possible transaction of which Meers knew on January 2 was the potential merger, and Sundstrand was to conduct its thorough on-site investigation before concluding any definitive merger agreement.* As of January 2, Meers did not know that Sundstrand was going to buy or even consider buying Huarisa's option. He thought Huarisa was going to

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* There is no evidence that Meers thought that the facts relating to deferred preproduction costs and other items questioned by Burke would not be disclosed to Sundstrand during the upcoming investigation. Sundstrand already knew that SKI had large amounts of deferred preproduction costs on its books, and Sundstrand's president instructed the survey team to investigate this item thoroughly. In fact, Sundstrand did learn the facts relating to SKI's deferral of preproduction costs during its investigation and concluded that it would not go ahead with the merger because, in part, of concern about those costs.

Indeed, it is doubtful that the Burke matter was even material, since the only fact which Sundstrand did not know was that, in spite of assurances by management and Price Waterhouse, Burke did not agree with the policy of deferring these costs. Sundstrand's original complaint did not even complain of the omission to disclose the Burke report, but rather relied upon misrepresentations allegedly made by the defendants.

exercise the option himself. Finally, Meers honestly thought, as a result of the extensive meetings and consideration given to the Burke matter in mid-1968 (including consultation with Price Waterhouse and the SEC, an agency not reticent in taking action regarding disputed issues of accounting and financial reporting) that Burke and the Ernst & Ernst accountant were wrong and that management and Price Waterhouse were correct. There was nothing that Meers thought was wrong with SKI's accounting, and consequently, he had no reason to perceive any need for disclosure.*

Meers learned that Sundstrand *had* agreed to buy the Burke stock at the earliest on January 8. He was not involved in that transaction at all.** He was not told that the contract had not yet been signed or that it was to be signed the next day. Sundstrand did not even tell him of the transaction, much less consult with him about it or ask for any information. Nothing had changed his honest opinion that Burke was wrong and that SKI's accounting, vouched for by management and Price Waterhouse, and unquestioned by the SEC, was proper. SKI's attorney, who had said that disclosure of the Burke matter was not necessary, had not changed his advice. Thus, any failure to disclose in the 24-hour period prior to Sundstrand's execution of the agreement on January 9 was not the result

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* In mid-1968, Meers reasonably and diligently did all that can be expected of an outside director on an accounting dispute such as the one here. The Seventh Circuit's standard which requires disclosure of things which Meers actually believed to be incorrect is untenable and improper.

** Meers was not a purchaser or seller, nor did he get any commission for Sundstrand's acquisition of the option or the Burke stock. Thus, there was no financial gain of any kind to improperly motivate any nondisclosure by him.

of any conscious decision not to disclose in order to deceive Sundstrand; nor was it the result of bad faith.

By ignoring Meers' good faith, and by imposing liability for failing to disclose facts which Meers honestly did not think had merit or were important, but which the Seventh Circuit now thinks an objective, reasonable man would have regarded as important, the Seventh Circuit has eliminated the scienter requirement in nondisclosure cases under Rule 10b-5 and predicated liability upon negligence.

Furthermore, Meers has been the victim of an injustice. He has been involved in this litigation for eight years. On the first trial he was exonerated. After the second trial, he was found liable for negligence on a very dubious basis. Then on appeal, this supposed negligence has been escalated to "recklessness"—the "legally functional equivalent for intent". (App. 93.) Since it is well known that this Court in *Ernst & Ernst* interpreted Rule 10b-5 to require an intent to deceive, manipulate or defraud, the Seventh Circuit's decision that this standard was met tars Meers with intentional wrongdoing—something no Court has ever found. The Seventh Circuit's new standard is bad in conception and its vices are manifest in the instant case. It should be rejected by this Court.

II.

IF RECKLESSNESS BY THE DEFENDANT IS SUFFICIENT FOR LIABILITY, RECKLESSNESS BY THE PLAINTIFF SHOULD BE A DEFENSE.

In the instant case, the Seventh Circuit imposed liability upon Meers for "reckless" conduct, *i.e.*, a failure to exercise sufficient care. At the same time, it rejected Meers' defense that Sundstrand was at least equally reckless in its acquisition of the Burke option. Indeed, Sundstrand was more careless than Meers.

On January 8 (at the earliest), Meers learned that Sundstrand had agreed to buy the Burke stock. He did not, however, know that the agreement had not yet been signed and would be signed the next day, January 9. Meers is held liable for failing to realize that Sundstrand needed to be informed of the Burke report (which Meers honestly did not consider to be meritorious) and failing to call Sundstrand within a matter of hours before it signed the agreement on January 9.

But compare Sundstrand's conduct. Sundstrand knew from SKI's 1967 annual report that SKI had substantial deferred preproduction costs on its books, and had discussed the matter with Huarisa in November, 1968. The Sundstrand investigation team had been directed by Sundstrand's president to investigate that matter thoroughly. The team was actually at SKI's east coast facilities that very week conducting the investigation, two full days of which were completed on January 7 and 8, *before* the contract was signed on January 9. Sundstrand's officers could have called the team on January 6 or 7, told them to look into the preproduction cost item on a priority basis, and to report back before the contract was signed. Or the signing of the contract obligating the payment of $334,785 could have been delayed a day or two to permit consultation with the team, or could have been made subject to an audit. Sundstrand took none of those actions. Sundstrand's officers could even have called Meers, told him that a contract was to be signed on January 9, and asked him if there was to his knowledge any matter which they should consider before going ahead. Instead, Sundstrand deliberately acted to keep Meers in ignorance of this transaction. Meers should not be held liable for Sundstrand's failure to take sufficient time to consider the facts available to it, or for Sundstrand's failure to complete the investigation that it told Meers it was going to make

prior to taking any action. Sundstrand's hasty action in purchasing the option was much more reckless than any inaction by Meers.

It is totally inappropriate to impose liability upon a defendant when the plaintiff's conduct was more reckless, a greater failure to exercise proper care. Under such circumstances, it is the plaintiff's own conduct rather than the defendant's which causes its injury.

Consequently, it should be a defense in a Rule 10b-5 case, that the plaintiff's conduct was either equally at fault or more at fault in causing the plaintiff to be injured. It does not serve any useful purpose to allow plaintiffs to recover from defendants whose conduct is not more culpable. Indeed, plaintiffs should be required to exercise due care to protect themselves in securities transactions. The result of allowing the due care defense will be to promote prudent conduct by everyone.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this Court should grant the Petition for a Writ of Certiorari to review the decision of the United States Court of Appeals for the Seventh Circuit.

Respectfully submitted,

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APPENDIX

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Section 10(b) of the Securities Exchange Act of 1934
15 U.S.C. § 78j(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means of instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5
17 C.F.R. § 240.10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

SUNDSTRAND CORPORATION,

Plaintiff,

vs.

SUN CHEMICAL CORPORATION, et al.,

Defendants.

NO. 69 C 1660

MEMORANDUM OPINION
January 23, 1977

I.

This long-contested action was filed on August 9, 1969, by Sundstrand Corporation ("Sundstrand") against Standard Kollsman Industries, Inc. ("SKI"), John B. Huarisa and Henry W. Meers, alleging violations by the defendants of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission, 17 CFR 240.10b-5.[1] Jurisdiction of this court is based on Section 27 of the Act, 15 U.S.C. §78aa.

[1] Rule 10b-5 provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud.

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

The transactions in dispute occurred on January 9, 1969, when Sunstrand, in connection with merger negotiations which were then taking place between Sundstrand and SKI, transferred to Huarisa 5,685 shares of Sundstrand common stock, in exchange for the right to acquire a block of 223,190 shares of SKI common stock owned by the Burke family on which Huarisa had a right of first refusal; and on February 6, 1969, when Sundstrand paid $6,360,915 for that stock. The gravamen of Sundstrand's complaint is that Huarisa, Meers and SKI conspired to violate and did violate Rule 10b-5 by misrepresenting material facts and failing to disclose material facts about the performance and financial condition of SKI during the merger negotiations which resulted in Sundstrand's purchase of the SKI stock. Huarisa has filed a counterclaim alleging that Sundstrand is obligated to repurchase from him the 5,685 shares of Sundstrand stock transferred to him.

This case was originally tried by another judge of this court from September 21 to December 8, 1971. At the close of Sundstrand's case, the trial judge granted defendants' motions to dismiss under F.R.Civ. P. 41(b). The Court of Appeals reversed, principally on the ground that the trial judge had unduly limited the scope of Sundstrand's proof, and remanded for a new trial. 488 F.2d 807 (1973). The case was tried in this court without a jury from September 16 to October 8, 1975. The following constitutes the findings of fact and conclusions of law as required by F.R. Civ P. 52.

The Parties

Sundstrand is a Delaware corporation, with its principal place of business in Rockford, Illinois.

Sun Chemical is a Delaware corporation. On December 31, 1972, SKI was merged into Sun Chemical. Sundstrand subsequently filed an amended complaint, and Sun Chemical was substituted as a defendant for SKI. While Sun

Chemical is a defendant in this action, it has been on the other side of the question of the validity of SKI's public earnings statements. As a purchaser of a substantial block of SKI stock, it was a party-plaintiff in a case filed in the Southern District of New York, 69 Civ. 4374, against SKI, Price Waterhouse, Raymond Ryan and others alleging, *inter alia,* that the nine-months' earnings report issued by SKI in September, 1968, contained misrepresentations of material facts and failed to disclose material facts in violation of Rule 10b-5. That case has been settled.

Prior to the Sun Chemical merger, SKI was an Illinois corporation with places of business in Melrose Park, Illinois, and other locations within the United States. SKI was publicly owned, and its common stock was traded on the New York Stock Exchange. At all relevant times SKI had approximately 2,380,000 shares of common stock outstanding. In making financial reports to its stockholders and the public, SKI generally consolidated the financial information for itself, Kollsman Instrument Corporation ("KIC") and its other subsidiaries.

KIC was the principal subsidiary of SKI. In 1967 and 1968, about two-thirds of the consolidated sales of SKI and its subsidiaries were attributable to KIC, and the financial results of KIC were the principal determinant of SKI's profit or loss position. During the relevant time period, all the members of the SKI Board were also directors of KIC and at least four persons, including Huarisa and Ryan, were officers of both SKI and KIC. KIC conducted its business through several divisions, one of which was the Avionics Division. The Avionics Division manufactured commercial and military aircraft instrumentation.

At all relevant times John B. Huarisa was Chairman of the Board and President of SKI.[2] He owned 172,000 shares

[2] Huarisa resigned as President of SKI on about March 5, 1969. He continued to serve as Chairman of the Board until December 29, 1972.

of SKI stock which he had acquired as part of the arrangements made in connection with his becoming the chief executive officer, at an average cost of $8.75 per share. Huarisa also held a right of first refusal on additional shares of SKI common stock owned by the Burke family interests, pursuant to a Pooling Agreement dated February 23, 1967.[3] It was this stock which Sundstrand paid for on February 6, 1969. In May, 1975, Huarisa died, and Thomas B. Hart and Raymond F. Ryan, as co-executors of Huarisa's estate, were subsequently substituted as defendants for Huarisa.

Defendant Raymond F. Ryan was Vice President and Treasurer of SKI from 1965 until 1969 and was responsible for the issuance of the financial statements of SKI and subsidiaries. Although Ryan left SKI in July, 1971, and went into business as a consultant, when the first trial of this case commenced in September, 1971, his only client was SKI which was paying him $4,100 per month. Thereafter, in early 1973, he joined a company known as Stancomp, Inc., as its president. That corporation was formed to purchase the assets of the Tuner Division of SKI. Until his death Huarisa was Chairman of the Board of Stancomp, Inc., and Ryan's superior. Huarisa and Ryan were the only stockholders in Stancomp, Inc.

Defendant Thomas B. Hart, Jr., is a partner in the law firm of Pope, Ballard, Shepard & Fowle, attorneys herein for Sun Chemical and for Ryan and Hart as co-executors of Huarisa's estate.

Henry W. Meers was a director and stockholder of SKI from May, 1967, until May, 1970. In 1968 he received $7,500 from SKI as director fees. Meers was a broker en-

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[3] See *infra* p. 14.

gaged in the sale of securities and a managing partner in the Chicago office of White, Weld & Company ("White, Weld"). White, Weld is a partnership which is a registered broker-dealer whose business includes acting as an underwriter of securities and as a business broker for corporations seeking to acquire or be acquired by other corporations. In early 1968, White, Weld served as a co-managing underwriter of a public offering by Sundstrand of its securities. As a managing partner of White, Weld, Meers personally performed services on behalf of Sundstrand in connection with the offering and thereby became acquainted with James W. Ethington, then president of Sundstrand, and certain of its other officers. Farwell Smith, a partner in White, Weld, worked under Meers in connection with the underwriting of Sundstrand securities and thereafter, up to March, 1969, made regular business calls on Sundstrand in Rockford.

The Merger Negotiations

The purchase and sale of securities out of which this case arises took place in the context of merger negotiations between Sundstrand and SKI. In the late summer of 1968, Huarisa and SKI were searching for a company suitable for a merger with SKI. Meers and Huarisa had first discussed the subject as early as the spring or early summer of 1968. Meers had, at that time, recommended several companies, including Sundstrand, to Huarisa as good merger prospects.

At the same time that SKI was looking for prospective merger partners, other companies were considering acquisition of SKI. In September, 1968, Riker Video Industries, Inc., announced its intention to make a tender offer to SKI stockholders to acquire all of SKI's outstanding shares.

The Riker Video proposal was discussed at the SKI board meeting on October 21, 1968. It was concluded that Riker Video should not be given serious consideration as a possible merger candidate.

By November, 1968, Wubbenhorst, an officer of KIC, had specifically been assigned the job of investigating various merger candidates and was writing a series of memoranda on the subject. He and Ryan concluded that Sundstrand was a good candidate.

In early or mid-November, 1968, Huarisa, after discussing the possibility of a merger with Sundstrand with Meers several times, directed Meers to get in touch with Sundstrand and see if they were interested in a merger with SKI. Meers telephoned James Ethington, president of Sundstrand, and inquired as to his interest in a merger and informed him of SKI's 1967 earnings ($1.30 per share) and its published earnings up to that time. Ethington, after conferring with Louis Schuette, vice chairman of the Sundstrand board and chairman of the Sundstrand executive committee, told Meers that Sundstrand would be interested in having further discussions.

Following this call, Ethington, Louis H. Schuette, Carl L. Sadler, Jr., executive vice president of Sundstrand, and other representatives of Sundstrand met with Huarisa in a series of meetings in Illinois, New York and Connecticut, to learn more about each other's companies and to consider the feasibility of a merger. These meetings occurred on November 19 and December 3, 17-19 and 26, 1968. During these meetings Huarisa confirmed to officers of Sundstrand that SKI's earnings for the first three quarters of 1968 were 86 cents per share, as reported in the published nine-months' earnings statement.

On November 19, 1968, Ethington, Huarisa, Schuette and Farwell Smith, a partner of Meers at White, Weld, met at the Chicago Club in Chicago to discuss a possible merger of Sundstrand and SKI. Smith substituted for Meers, who was out of town. At that meeting Huarisa said that SKI was looking for a merger partner in view of the attempt by Riker Video Industries, Inc. to take over SKI and merger proposals by a number of other companies; that merger negotiations would have to be based upon SKI's projected earnings and that SKI was preparing projections for 1969; and that SKI earnings for the first quarter of 1969 would be substantially better than SKI's past history. Huarisa also stated that SKI's poor results for the fourth quarter of 1967 were the result of some problems they had had; that the Avionics Division had lost money, but that he now had Avionics turned around and he expected SKI to make more money in 1968 than it did in 1967. Also at that meeting, Schuette asked Huarisa to prepare a projection of SKI earnings for 1968 and 1969.

A second meeting was arranged for the morning of December 3, 1968, at the Sundstrand corporate offices in Rockford, Illinois. Huarisa met at various times that day with Ethington, Sadler, Schuette, Bruce Olson, chairman of the Sundstrand board, and Burnell Gustafson, a vice president of Sundstrand. At one or more of these meetings, Huarisa said that he would prefer to wait to negotiate the merger until SKI's financial results for the first quarter of 1969 were available, but that he was concerned about a possible take-over of SKI by another corporation and there was a need to proceed rapidly if Sundstrand was interested in a merger.

At one of the meetings on December 3, 1968, Huarisa informed Ethington and Schuette that SKI's net income for 1968 would be between $2,600,000 and $2,900,000, that

SKI's 1968 earnings per share would be about $1.16, and that earnings for the year 1969 would be about $2.41 or even $2.50 per share. He said that the 1969 projection should be the basis for negotiations.

Although Huarisa denied that he advised Sundstrand of SKI's expected 1968 earnings on December 3, 1968, the consistent testimony of Ethington and Schuette that such information was furnished, as well as Ethington's contemporaneous notes of the meeting, support the conclusion that he made this estimate of earnings. It is implausible that the parties would discuss a proposed acquisition of SKI in December of 1968 without considering SKI's 1968 earnings. Huarisa stated in the SKI board meeting of January 2, 1969, that he had told Sundstrand that SKI would earn about $1.14 per share. The foregoing finding is further supported by the testimony of Krinsly, an officer of Sun Chemical, that Huarisa told him less than two weeks after that SKI's 1968 earnings would be $1.15 per share.

On December 17 through 19, 1968, Evans Erikson, vice president of Sundstrand's aerospace group, and Sadler, together with Huarisa, visited SKI's manufacturing and executive facilities in Elmhurst and Syosset, New York (KIC) and in Bridgeport, Connecticut (Casco Products Corporation). On December 18, 1968, during a ride from Syosset to New York City, Huarisa told Sadler and Erikson that Sundstrand would have to give SKI a positive indication of interest in a merger before a divisional breakdown of SKI's 1969 earnings projection of $2.41 per share and other underlying SKI financial information would be divulged. Huarisa also told Erikson and Sadler that such a proposal by Sundstrand would have to be made before January 1, 1969, because of the pressure from other companies interested in taking over SKI. During this time

Huarisa also said that other companies were anxious to acquire SKI and that Sundstrand would have to pay significantly more than $30 per SKI share in order to acquire SKI.

During the period from mid-November through December 26, 1968, Meers had several conversations with Huarisa concerning the possible acquisition of SKI by Sundstrand in which they discussed Huarisa's meetings with Sundstrand.

On the morning of December 26, 1968, Huarisa met with Ethington, Olson, Sadler and Schuette in the Sundstrand corporate offices in Rockford. At this meeting Huarisa gave Sundstrand representatives an additional written projection which showed 1969 earnings of $2.13 per share, stating that it was very conservative and that SKI should earn $2.41 or even $2.50 per share in 1969. Huarisa indicated that the 1968 earnings, as reported, were $.86 a share and that in no case would there be adjustments which would affect what had already been reported. Huarisa also said that a Sundstrand offer of $32.75 for each share of SKI stock was probably too low because he had offers as high as $45 a share. (In fact, SKI had received no acquisition or merger offers at the time such statement was made, except for one which Huarisa deemed frivolous.) Huarisa said Sundstrand should negotiate a price with Meers.

Huarisa called Meers after he left Rockford on December 26 and had lunch with Meers. They discussed the negotiations with Sundstrand, and Meers agreed to handle the merger negotiations for Huarisa. They agreed that they would try to get the best deal they could. Huarisa told Meers that he thought SKI's 1969 earnings would be be-

tween $2.00 and $2.50 per share. Meers considered Huarisa a client of his firm and told him that there would be a fee involved if the merger was consummated.

Ethington and Schuette then met with Meers for three hours on the afternoon of December 26, 1968, to negotiate a price for Sundstrand's proposed acquisition of SKI. Meers testified at trial that he was acting as an agent for Huarisa during this meeting. During the meeting Meers periodically called Huarisa to get his comments on the successive proposals made by Sundstrand. Meers first called and transmitted an offer equivalent to $32.75 per share. Huarisa told Meers that he (Meers) knew what SKI's earnings were and said that SKI had had discussions with other companies at much higher prices and that $32.75 was not enough. Ethington and Schuette made further calculations and offered $36 per share which Meers relayed to Huarisa and which Huarisa also rejected as too low. During the meeting Meers told Ethington and Schuette that Sundstrand had had discussions with other companies at prices as high as $45 per share. Ethington told Meers that he was basing his offers on SKI earnings of $1.16 per share in 1968 and $2.00 per share in 1969, even though Huarisa had projected $2.13 to $2.41 per share for 1969. Meers replied that Ethington's earnings figures were reasonable. Ethington and Schuette made a third and final offer equivalent to $38.25 per share of SKI stock. Huarisa agreed to submit that proposal to the board of directors and the stockholders.

After Huarisa's acceptance of the offer, it was agreed that Ethington and Schuette would return to Rockford to type up the proposal in final form. It was also agreed that Meers' firm, White, Weld, would receive a $150,000 fee if the merger was consummated. There was no discussion of

anything further that White, Weld would have to do to earn this fee.

Meers' testimony that he did not discuss SKI earnings on the afternoon of December 26 is not plausible. Meers admitted that Huarisa mentioned the 1969 projection of $2 to $2.50 per share at lunch that day and again mentioned earnings projections during at least one of their phone calls that afternoon. The subject of the negotiations was how much Sundstrand would offer for each SKI share. Ethington testified that he was concerned that a merger not result in a dilution of Sundstrand's earnings per share and that Sundstrand's offers were based on SKI's earnings. The conclusion is irresistible that SKI's earnings must have been a central part of those negotiations. Finally, defendants' effort to impeach the testimony of Ethington in this regard failed. Ethington's testimony at the first trial of this case was virtually identical, and his deposition testimony on the point is not inconsistent, with his testimony at trial.

As agreed at the meeting, Sundstrand drafted a proposal that, subject to its conducting a survey of the business of SKI and certain other conditions, Sundstrand would acquire the assets of SKI subject to its liabilities, in exchange for Sundstrand common stock at a market value approximately equivalent to $38.25 for each outstanding share of SKI stock. Ethington delivered the written proposal to Meers on December 27, 1968, and Meers delivered it to Huarisa at his home on December 28, 1968. Under the Sundstrand proposal, taking into account the 172,000 shares of SKI stock he owned, Huarisa stood to profit personally by about $5,200,000.

On January 2, 1969, the SKI Board of Directors considered Sundstrand's proposal. At that meeting Huarisa informed the Board, including Meers, that he had told Sundstrand that SKI earnings for 1968 would be about $1.14 per share and that its 1969 earnings would be between $2.00 and $2.50 per share. He further acknowledged, in answer to a question by James W. Burke, Jr., one of the directors, that he had not advised Sundstrand of the "Burke Report."[4] The Board authorized Huarisa to proceed on the basis of Sundstrand's proposal. On the same date the proposal was made public.

Meers contradicted Burke's testimony that at the January 2 Board meeting Burke asked questions of Huarisa and Meers as to whether Sundstrand had been advised of SKI's projected earnings and Burke's raising accounting questions. To the extent that there is a conflict in the evidence, the court finds that, based on all the evidence, Burke's testimony in this regard is more credible.

Sundstrand's Purchase of the SKI Stock

On January 4, 1969, Huarisa called Ethington and said that he had a problem with a block of stock on which he had to exercise an option by January 9, 1969. On January 6, 1969, Ethington, Huarisa, W. McNeil Kennedy, an attorney for Huarisa and also a SKI director, Charles E. Pitte, Jr., a partner in the law firm representing Sundstrand, and others met in Kennedy's office in Chicago. At this meeting, Huarisa and his attorneys informed Sundstrand that Huarisa had received from the Burke family an offer to sell to him at $30 per share 223,190 shares of SKI stock covered by his right of first refusal in the Pooling Agreement dated February 23, 1967. This offer to sell by the Burke family had been communicated to Huarisa on December 10, 1968.

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[4] See *infra* at 27. [App. 25-26.]

Under the terms of the pooling agreement, Huarisa had a right of first refusal on a large block of stock held by or in trust for members of the Burke family.[5] In order to exercise this right, Huarisa had to make a payment of 5% of the price of the stock within 30 days of being notified of an offer to purchase the stock by another party and an intent by the Burkes to sell. A further payment of 20% had to be made within 60 days and the entire amount had to be paid within 120 days. If any payment was not made according to the terms of the agreement, all restrictions on the sale of the stock lapsed and any prior payments made were forfeited.

Because Huarisa had received the Burkes' offer to sell on December 10, 1968, the thirty days within which Huarisa had to make the first 5% payment would end on January 9, 1969, at which time Sun Chemical, which had made the offer to the Burkes, would have an unconditional right to purchase the stock. Huarisa said that if Sun Chemical got this stock, Sundstrand and SKI could forget about the proposed merger. Huarisa and his counsel told Sundstrand that certain legal obstacles made uneconomic,[6] and thereby prevented, Huarisa's purchase and retention of that stock if SKI and Sundstrand were to merge. At that meeting Ethington stated that Sundstrand would be interested in buying the stock only if it thought the proposed merger

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[5] The Burkes are the family of the founder of Standard Kollsman, James O. Burke.

[6] Huarisa was advised by his counsel that he faced possible substantial liabilities under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78p(b), and Section 356 of the Internal Revenue Code, 26 U.S.C. §356, if he purchased the stock himself and the merger went through.

was going to take place. In response to Ethington's question, Huarisa said that SKI's 1968 and 1969 earnings projections still looked good. Ethington, on behalf of Sundstrand, orally agreed to purchase the 223,190 shares of SKI stock from Huarisa at $30 per share. Because of concern that Sun Chemical would attempt to upset the transaction if it learned of Huarisa's sale of the Burke stock to Sundstrand, it was agreed not to disclose the sale publicly.

Meers was not present at, nor was he consulted by Sundstrand in connection with, this meeting. However, he had been aware that Huarisa had a right of first refusal on the Burke stock since before he became a director of SKI and had known of Sun Chemical's offer for the Burke stock since early December, 1968. At that time Meers received a telephone call from Gus Levy, senior partner of Goldman Sachs, who stated that his client, Alexander of Sun Chemical, had almost 20% of SKI's stock and would appreciate Meers' cooperation. Meers then called Huarisa who said that was not true since he still had a right of first refusal on the Burke stock. Meers then called Levy and advised him of Huarisa's right of first refusal. A day or two after Huarisa's January 6, 1969, meeting with Ethington, Meers discussed with Huarisa Sundstrand's prospective purchase of the Burke stock.

On January 8, 1969, Huarisa took the first step toward exercising his right of first refusal by delivering to the Burke family his written election to purchase and five percent of the purchase price, $334,785. On January 9, Sundstrand and Huarisa entered into a stock purchase agreement which provided, in relevant part, that:

> "1. Huarisa hereby sells, transfers and conveys to Sundstrand the 223,190 shares of common stock of Standard Kollsman Industries Inc. ("SKI Shares")

referred to in the Offer to Sell and related Pooling Agreement, subject to payment by Sundstrand of the unpaid balance of $6,360,915.00 due under the terms of the Offer to Sell. . . . [U]pon such payment of the unpaid balance by Sundstrand, Sundstrand shall have valid title to the SKI shares. . . .

"2. Sundstrand hereby sells, transfers and conveys to Huarisa 5,686 shares of common stock of Sundstrand. . . .

"3. . . . .

"4. (a) Sundstrand agrees that at any time or times within two (2) years from the date hereof it will purchase from Huarisa all or any part of the Sundstrand Shares described in paragraph 2 hereof for the cash price of $58.875 per share (which is the closing price of the Sundstrand common shares on the New York Stock Exchange on January 8, 1969) within fifteen (15) days after receipt by Sundstrand of written notice from Huarisa that he exercises his right to sell as provided in this paragraph 4(a). . . ."

This agreement was entered into in contemplation of and in connection with the proposed merger. On January 9, 1969, Sundstrand's information with respect to the earnings and financial condition of SKI consisted solely of that obtained from published sources and the statements of the defendants. Public information and statements of the defendants which were particularly relied upon by Sundstrand in entering into this agreement were the reported earnings of 86 cents per share for the first nine months of 1968, the statements that SKI's earnings would be about $1.16 per share for the entire year 1968, the statements

that the Avionics Division had been turned around and the earnings projections for 1969 of at least $2.13 per share in 1969.

There is no question that, by entering into the agreement of January 9 Sundstrand obligated itself to convey to Huarisa 5,686 shares of Sundstrand stock to compensate him for his payment of $334,785 under the terms of the Pooling Agreement. Thus, the defendants' liability for misrepresentations and omissions made in connection with Sundstrand's transfer of these shares to Huarisa depends on what was said, or not said, and what Sundstrand knew, or did not know, as of January 9, 1969.

The parties dispute strenuously the question of whether or not, by signing the agreement, Sundstrand also purchased, at least for the purposes of Rule 10b-5, the entire block of Burke stock at that time. Sundstrand argues that it acquired the Burke stock on January 9, 1969, and that the payment of $6,360,190 made on February 6 was simply the final payment for an already consummated deal. Under this interpretation, the defendants' liability with respect to the Burke stock is to be judged by conditions as they existed on January 9. Defendants assert that the purchase of the Burke stock occurred on February 6. As a consequence of this interpretation, they argue that the question of liability must be approached in terms not only of what the defendants said, or did not say, but also in terms of what Sundstrand found out for itself in its survey of SKI conducted during January, 1969. This investigation, defendants claim, made Sundstrand aware of all relevant information about SKI's financial prospects and rendered harmless any misrepresentations which may have been made. (Defendants do not, of course, admit that any misrepresentations were made.)

The court finds that the purchase of the Burke SKI stock occurred on February 6, 1969. Under the terms of the January 9 agreement, Sundstrand was under no legal obligation to make any further payments toward the purchase of the Burke stock, and Huarisa was only obligated to make the transfer of the stock to Huarisa "subject to payment by Sundstrand of the unpaid balance of $6,360,915 due under the terms of the Offer to Sell." The only relevant obligation [7] imposed on Sundstrand by the agreement was to indemnify Huarisa for his 5% initial payment made to keep the Burke stock out of the hands of Sun Chemical for another thirty days. By the agreement, Sundstrand secured an option to purchase the Burke stock by making further payments according to the terms of the Pooling Agreement. Sundstrand's position was the same as Huarisa's under the Pooling Agreement. It could make the further payments and get the stock, or it could decline to go through with the deal and forfeit the payment already made.

This is both the most reasonable reading of the terms of the agreement and the most reasonable sort of agreement for the parties to have entered into at that point. Sundstrand's reason for making the agreement was to prevent Sun Chemical from acquiring a block of SKI stock large enough to frustrate the Sundstrand-SKI merger before Sundstrand could complete the investigation needed to decide whether to go through with the merger. In order to do this, it needed only to block Sun Chemical's acquisition of the stock long enough to complete its investigation.[8]

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[7] Other obligations imposed by the agreement are of no consequence to this issue.

[8] This interpretation of the January 9 agreement is in accord with that of the Court of Appeals, 488 F.2d 807, 810 (7th Cir. 1973).

Continued Merger Negotiations After January 9, 1969

Having thus preserved the possibility of a merger, Sundstrand began a survey of various aspects of the operation of SKI to determine whether or not the merger should be consummated. On January 9 and 10, 1969, officers and employees of Sundstrand, who were part of the survey team, met with Ryan, Werle, Katz, and other financial personnel of KIC at the SKI facilities in Elmhurst and Syosset, New York. On January 13 and 14, 1969, Donald Miller, Sundstrand's Controller, and his assistant visited Ryan at the SKI offices in Melrose Park, Illinois. On January 16, 1969, Miller and Ross met with Ryan and Werle at the offices of SKI in Melrose Park, Illinois. In one or more of such meetings, SKI representatives made the following representations of material fact:

(a) That each quarter KIC reviewed the status of each long-term contract and the estimated cost to complete it and that, if the review disclosed that losses would be incurred on the contract, KIC's practice was to write off immediately the total amount of such losses.

(b) That as a result of the last such review, $600,000 had been written off against Avionics Division income for the month of November, 1968, and that, except for that write-off, KIC would have made a profit in November.

(c) That by the fourth quarter of 1968, general and administrative expenses of KIC had been reduced from $8,000,000 to $6,000,000 on an annualized basis, and that the Avionics Division was profitable in the fourth quarter of 1968 as a result of the profit improvement program.

(d) That SKI's earnings for the then completed year 1968 would be about $1.15 to $1.20 per share and that SKI earnings for the year 1969 would be a little over $2 per share.

(e) That SKI's earnings for the eleven months ended November 30, 1968, were $.84 per share.

(f) That the SKI financial results for December, 1968 would be very good and that, despite the results through November 30, 1968, SKI would meet its 1968 earnings projection.

(g) That the maximum amount of preproduction costs which would be written off by KIC for 1968 was $902,000, consisting of $151,000 of such costs on the KS-200, $72,000 on the AAU-19, $526,000 on the CPU-46, $96,000 on the 4201 airspeed indicator, and $57,000 on products to be used on the Boeing 747. (Sundstrand was also shown a document reflecting these figures as the "Amount of Write-Off—1968," and the same amounts were recorded by Ross in his notes.

(h) That SKI expected to write off less than $902,000 of deferred preproduction costs for 1968 after discussions with its auditors.

(i) That the only portion of the $902,000 which SKI was definitely going to write off in 1968 was the $96,000 of deferred preproduction costs on the 4201.

(j) That KIC evaluated its inventory for obsolescence, that a physical inventory in KIC had been taken at mid-year 1968, that the inventories on KIC's books were good and that the reserve for obsolescence in the amount of $183,000 at November 30, 1968, would be more than adequate to cover any obsolescent inventory.

At trial, Ryan denied that statements were made as to a $600,000 November write-off in the Avionics Division, or as to the level of earnings of SKI for December or for all of 1968. The court finds that Ryan's testimony is not credible and is against the weight of the evidence. Ryan is strongly identified with the defendants' interests in this litigation. As Ryan himself admitted, Werle did most of the talking at their meetings with Sundstrand, and defendants did not offer any testimony of Werle in that regard. Both Ross and Miller testified as to statements made with regard to the $600,000 November write-off. Further support is provided by Ross' handwritten notes. Ryan's testimony that he gave no projections of 1968 earnings to Miller is likewise not credible. Miller appeared pursuant to subpoena and testified as an independent witness, not having been associated with Sundstrand since 1971.

Though defendants Sun Chemical and Huarisa claim that Sundstrand had full access to all relevant sources of information during the survey, such was not the case, particularly with respect to financial information. While KIC personnel were instructed generally to make requested information available to the Sundstrand team, this directive explicitly excluded financial information. All requests for financial information were to be referred to Ryan and Werle. Ryan and Werle, who reported directly to Huarisa, determined what financial information Sundstrand would receive. In addition, on the day that the survey began, Ross was told that the Sundstrand team would not be seeing David B. Nichinson, the chief executive officer of KIC, SKI's most important subsidiary, because he had resigned. In fact, Nichinson had not resigned, but had been summarily removed from his position by

Huarisa. This action was prompted, at least in part, by Nichinson's disagreement with Huarisa over how much earnings KIC would be able to report in 1968 and 1969.[9]

On January 17, 1969, Werle furnished to Miller by phone, and confirmed by letter, further information regarding preproduction costs. He stated that $30,000 of preproduction costs on the CPU-46 were "covered," and $876,000 of preproduction costs on the AAU-19 were "covered". Implicit in these statements was the representation that the contracts would be profitable, since an unprofitable contract would produce no gross profit to "cover" any preproduction costs.

Except for the write-offs of preproduction costs of $902,000 or less, at no time prior to February 6, 1969, was Sundstrand advised of any write-offs or adjustments which were under consideration for the year-end 1968.

Upon returning to Rockford, Sundstrand personnel evaluated the information provided them by the SKI representatives. They concluded on January 20 that certain aspects of the SKI operation, including an increase in labor costs which a merger would cause, undesirable SKI labor practices, and lack of the expected compatibility of

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[9] In August, 1968, Huarisa told the president of KIC, David B. Nichinson, that he "had to have a couple of million dollars more" of KIC income in 1968. When Nichinson told Huarisa that it was not possible for KIC to earn more in 1968 than had previously been estimated, Huarisa responded that if Nichinson couldn't give it to him he "knew where he could find it." Thereafter, Huarisa reorganized the top management of KIC, announcing that George J. Werle, Vice President-Controller of KIC, would be responsible for all KIC financial affairs, that Mordecai D. Katz would be responsible for management of the Avionics Division and that both Werle and Katz would report directly to Huarisa rather than to Nichinson.

SKI's and Sundstrand's products, made the acquisition unattractive. The opinion was also expressed that SKI's earnings projections were somewhat optimistic. The Sundstrand personnel estimated, based on the information supplied, that SKI would earn about $.80 to $1.00 for 1968 and $1.45 to $1.50 and up for 1969. A decision was then made to cancel the negotiations.

The conclusion to cancel the negotiations was discussed on the evening of January 20, 1969, when Ethington and Schuette met with Huarisa and Meers at a hotel near O'Hare Airport. After Ethington and Schuette outlined the reasons the proposal was being cancelled, namely, increased labor costs which a merger would cause, lack of product compatibility and Sundstrand's reduced estimate of SKI earnings, Huarisa replied that SKI could prove that SKI would meet its earnings projections and that he wanted to meet again to demonstrate the validity of his position. At Meers' request, Sundstrand agreed to defer announcing termination of the merger proposal until they met again with Huarisa.

On January 22, 1969, Ethington, Schuette, Erikson, Miller, Huarisa, Meers and Ryan met at the Chicago Club. The Sundstrand people expressed their doubts about SKI's earnings projections. These doubts were founded in part on questions about SKI's deferral of preproduction costs on certain contracts and about the profitability of some contracts on which SKI was expecting a profit. Both Huarisa and Ryan said that SKI would be able to amortize these deferred preproduction costs in 1969 and thereafter. Huarisa assured Sundstrand that no more than $600,000 of preproduction costs would have to be expensed in 1968, and that even if that maximum write-off were made, earnings would not fall below the already reported $.86 per share.

With respect to the CPU-46, Ryan said that SKI would get orders for 3,500 units, that the total market was about 8,000 units, that SKI would pass certain tests and be placed on the government's Qualified Products List "any day," which would enable it to receive follow-on orders, and that it would in fact receive such orders. With respect to the AAU-19, Ryan said SKI had started delivery in 1968, anticipated a delivery rate of 150 to 250 units per month, that the total market potential was 30,000 units of which SKI would get at least 15,000 and that since SKI's only competition was Aerosonic Corporation, which was having delivery problems, SKI should get more than half of the market for the AAU-19. Ryan also said that the AAU-19 was probably one of the best programs that SKI had as far as future potential was concerned. With respect to the KS-200, Ryan said that despite declines in sales of the Boeing 727 and 737 aircraft, SKI's estimate of 500 units was still accurate. He also said that the total market for the KS-200 was over 1100 units and SKI was the sole source for the product.

Despite these assurances, Sundstrand adhered to its decision to call off the merger negotiations. At the close of the meeting, Ethington said that Sundstrand appreciated the efforts that SKI had made to supply them with information. He also said that Sundstrand was going to honor "its commitment" with respect to the Burke shares. On January 23, Sundstrand and SKI announced to the public that plans for the merger had been dropped.

On February 6, 1969, in accord with the terms of the January 6 agreement, Sundstrand made its payment for the Burkes' 223,190 shares of SKI common stock. The transaction was accomplished by Sundstrand's delivering to Huarisa's agents, who delivered to the National Boule-

vard Bank of Chicago as escrowee a cashier's check for $6,360,915.00, and the Burkes' delivering certificates for 223,190 shares of SKI common stock to the escrowee, who delivered them to Huarisa's agents, who delivered them to Sundstrand.

Although Sundstrand was under no legal obligation to make this payment, there is no doubt that Sundstrand, in completing this purchase, had a right to rely on and was in fact relying on what it had learned prior to the termination of the merger negotiations.

Subsequent Events

After completing its purchase, Sundstrand became aware of material misrepresentations and omissions on the part of the defendants.

On March 21, 1969, SKI published its 1968 Annual Report which reported a net loss after taxes equivalent to $.15 per share. A large part of the discrepancy between this year end loss and the reported earnings of $.86 per share for the first nine months of 1968 was attributable to large write-offs of deferred preproduction costs and the recognition of losses on several major contracts, including the CPU-46, the AAU-19 and the KS-200.

About March 21, 1969, Norman Alexander, president of Sun Chemical, telephoned Ethington and said that he had copies of reports on SKI by James Burke,[10] a director of SKI, and Ernst & Ernst, a firm of certified public accountants, and asked if Ethington knew of their existence. Ethington said that he had never heard of either report. When Alexander offered to let Ethington read them,

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[10] James Burke was a member of the family which owned the "Burke stock".

Ethington and Ross took a flight the next day to New York City, where they met with Alexander and Stuart Krinsley, vice president and general counsel for Sun Chemical. The reports questioned, as of May, 1968, the propriety of the continued deferral of preproduction costs and the failure to recognize losses on some of the contracts which resulted in the loss reported at year end 1968.

On March 27, 1969, Ethington called Meers who was vacationing in the Bahamas and told Meers that he had just gotten a copy of the Burke and Ernst & Ernst reports and that he was very upset that he had not been previously advised of these matters. Upon Meers' return, Ethington and Ross met with Meers. Ethington told Meers that he was very upset that he had not been advised that one of the SKI directors had questioned SKI's earnings and that he had not received the Burke and Ernst & Ernst reports. At trial, Meers acknowledged that he had not provided such information to Sundstrand and had not advised Sundstrand that Burke felt compelled to go to the SEC with his complaints.

After Sundstrand learned of SKI's financial results for 1968 and of the Burke and Ernst & Ernst reports, it unsuccessfully sought to dispose of its SKI stock. Unable to dispose of the stock, Sundstrand, through its counsel, wrote to SKI, Huarisa and Meers in July, 1969, demanding that the stock purchase be rescinded. Recission was refused, and this action was filed on August 9, 1969.

II.

It is apparent from the foregoing findings that the plaintiff became involved in the purchase of the Burke stock as a prelude to an anticipated merger. A merger is a purchase or sale of securities within the meaning of

Rule 10b-5. *Dasho* v. *Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967). The fact that Sundstrand, for reasons of its own, was unwilling to complete the merger does not deprive it of its rights as an investor. Thus, the various misrepresentations and omissions made by Huarisa, Meers and SKI in their merger negotiations with Sundstrand were in connection with the purchase of the stock by Sundstrand just as much as they were in connection with the proposed merger.

The liability of the defendants under Rule 10b-5 is not affected by the question whether the Burke family or Huarisa was the immediate seller of the stock purchased by Sundstrand. The rule in such cases is that persons other than the immediate seller who engage in conduct violative of Rule 10b-5 which causes the plaintiffs damage in connection with the purchase may be held liable.[11] See generally Bromberg, *Securities Laws: Fraud*, Sec. 8.5 (500), *et seq.* (1974); *Eason* v. *General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *G & M, Inc.* v. *Newbern*, 488 F.2d 742, 745 (9th Cir. 1973); *Freed* v. *Szabo Food Service*, CCH Fed. Sec. L.Rep. ¶91,317 (N.D.Ill. 1964) [1961-64 Transfer Binder]; *Cf. Sundstrand Corp.* v. *Standard Kollsman Industries, Inc.*, 488 F.2d 807 (7th Cir. 1973).

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[11] Rule 10b-5, adopted in 1942, has a broad remedial purpose, viz. to afford those engaging in securities transactions the protection of full disclosure by those with whom they deal. Rule 10b-5 "greatly expands the protection frequently so hemmed in by the traditional concepts of common law misrepresentation and deceit." *Hooper* v. *Mountain States Sec. Corp.*, 282 F.2d 195, 201 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961), and should be construed "'not technically and restrictively, but flexibly to effectuate its remedial purposes'." *Affiliated Ute Citizens of Utah* v. *United States, supra*, at 151, quoting *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963).

Material Misrepresentations and Omissions

To be actionable under Rule 10b-5, the statements of defendants must have contained material misrepresentations or defendants must have omitted to state material facts. With respect to omissions, such as the failure to disclose the Burke and Ernst & Ernst reports and the Price Waterhouse memorandum of January 27, 1969,

> "All that is necessary is that the facts withheld be material in the sense that a reasonable investor *might* have considered them important in making this decision [to sell certain stock]. (Emphasis added.) *Affiliated Ute Citizens of Utah* v. *United States,* 406 U.S. 128, 153-54 (1972).

See also *Northway, Inc.* v. *TSC Industries, Inc.,* 512 F.2d 324, 331 n.13 (7th Cir. 1975). A misrepresented fact will be deemed material if " 'a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question.' " *List* v. *Fashion Park, Inc.,* 340 F.2d 457, 462 (2d Cir. 1965). All of the misrepresentations and omissions discussed below were material.

A. *Misrepresentations and Omissions Prior to January 9, 1969.*

1. *Earnings Projections*

The earnings figures of $2,600,000 or $2,900,000 and $1.16 per share for all of 1968 which Huarisa represented to Sundstrand were grossly inflated. In 1968 SKI reported a loss of $367,803, equivalent to $.15 per share.

The projections of $2.50 and $2.41 per share earnings in 1969 and even the "conservative" projection of $2.13 were similarly overstated. The actual SKI 1969 earnings were only $.35 per share, and this low figure was in spite

of the fact that 1968, not 1969, bore the brunt of the write-off of preproduction costs. These 1968 write-offs, as publicly stated by SKI and Huarisa in late March, 1969, were "to insure that the company's earnings in 1969 and the years beyond are not compromised by past problems . . . ." Ryan testified that he told Sundstrand that the SKI projections for 1968 were based on the assumption that $900,000 of deferred preproduction costs would be written off in 1968. In fact, more than $2,400,000 of such costs were written off as of year-end 1968. Though write-offs of such magnitude should have increased the likelihood that SKI would realize its 1969 earnings projections, the earnings turned out to be only 16% of the "conservative" projection.

These representations as to the earnings for the entire year 1968 and the earnings for the year 1969 were clearly material. The SEC has said that "management's assessment of a company's future performance is information of significant importance to the investor. . . ." SEC Rel. No. 34-9984, 17 CFR 241.9984, CCH Sec.L.Rep. ¶23,508. See also *Marx* v. *Computer Sciences Corp.*, 507 F.2d 485, 489 (9th Cir. 1974). It is true that an earnings projection is not actionable simply because it turns out to have been too optimistic. *Securities and Exchange Commission* v. *R. A. Holman & Co.*, 366 F.2d 456 (2d Cir. 1966). However, an earnings projection will be found to be a "misstatement" unless it is "a reasonable and justified statement of opinion . . . with a sound factual or historical basis." *G & M, Inc.* v. *Newbern, supra,* at 745-46. See also *Marx* v. *Computer Sciences Corp., supra,* at 490-91; *Beecher* v. *Able,* 374 F.Supp. 341, 347-48 (S.D.N.Y. 1974); *Green* v. *Jonhop, Inc.*, 358 F.Supp. 413 (D.Ore. 1973).

The 1968 earnings projections made by Huarisa and SKI do not meet this standard. There is no evidence that these projections were reasonable statements or that they had any sound foundation. The evidence does show that Huarisa and SKI knew, or were reckless in not knowing, that the earnings reported for the first nine months of 1968, which were the foundation for the projection of the whole year's earnings, were grossly overstated and that nothing had occurred during the last quarter of 1968 which would even make up for that overstatement. The projection of 1969 earnings was also a misstatement. Huarisa, as chief executive officer of SKI, worked closely with Ryan, the chief financial officer, and was familiar with SKI's production and financial difficulties. Despite this knowledge, Huarisa told Sundstrand that he projected 1969 earnings to be between $2.50 and a "conservative" $2.13 per share. Defendants Sun Chemical and Huarisa presented no evidence to support this optimistic forecast. In fact, 1969 earnings were only $.35 per share, even though SKI wrote off more than $3,000,000 more than Huarisa said was the maximum possible write-off at year end 1968. These write-offs enhanced SKI's 1969 earnings. The inference is inescapable that Huarisa and SKI knew, or were reckless in not knowing, that the projected 1969 earnings given to Sundstrand were grossly inflated and without sound and reasonable basis and were, therefore, "misstatements of material fact" for the purposes of Rule 10b-5.

2. *Failure to Disclose the Burke and Ernst & Ernst Reports*

The defendants failed to disclose to Sundstrand that James W. Burke, a director, officer and large shareholder of SKI had, in May, 1968, formally submitted to the board of directors of SKI questions as to the propriety of cer-

tain SKI accounting practices, including that of continuing to defer certain preproduction costs on the CPU-46 and other programs. The questions related principally to accounting practices as revealed in the 1967 annual report. Burke supported his questions in June with a report from Ernst & Ernst, an independent firm of certified public accountants which Burke had asked to consider the propriety of the practices he challenged. Ernst & Ernst, though declining to render a formal opinion because it had not conducted an examination in conformity with generally accepted auditing procedures, concluded that the practices addressed in the Burke Report seemed questionable.

These reports were considered serious enough by the SKI board of directors to be discussed at at least twenty-five board meetings during the spring and summer of 1968. The board directed the officers of SKI to prepare responses to Burke's questions, and at Meers' request, representatives of Price Waterhouse, the firm of certified public accountants which prepared the SKI 1967 annual report, appeared at several of these meetings to discuss Burke's questions. The board eventually decided that Burke's criticisms were without merit. However, as a result of Burke's questions, the board began, in April, 1968, to receive monthly financial reports. These reports revealed the continual increase of deferred preproduction costs on the CPU-46 and other programs throughout 1968. Meers was concerned enough to ask about the progress of each of the contracts on which costs were deferred, including the CPU-46, at every board meeting and asked particularly whether the CPU-46 had been qualified with the government—a step which was essential to producing an acceptable product and obtaining follow-on contracts. In each such meeting he learned that no such qualification had been obtained. (In fact, qualification was not obtained until September, 1969.)

Dissatisfied with the board's action, Burke complained to the SEC. Ryan, Hart, acting as attorney for SKI, and H. Dudley Murphy, a partner of Price Waterhouse, met in Washington with Curtis A. Davies of the SEC to discuss Burke's charges. At that meeting it was concluded that the 1967 annual report did not reflect improper accounting practices. With respect to preproduction costs on the CPU-46, Murphy assured Davies that Price Waterhouse would re-evaluate the situation when they prepared the 1968 annual report. This assurance was reiterated in a letter from Murphy to Davies. Both Ryan and Meers saw copies of that letter. None of this was disclosed to Sundstrand.

Neither was it disclosed that, because of questions about the propriety of SKI's 1967 financial statements, two directors of SKI, Burke and Perry Addleman, refused to sign a registration statement filed by SKI with the Securities and Exchange Commission in March, 1968. Meers later suggested that the registration statement be withdrawn, which was done in August, 1968. In addition, defendants failed to disclose to Sundstrand that Addleman also raised questions about the financial accounting of SKI.

Defendants argue that, for a number of reasons, there was no actionable failure to disclose in connection with the Burke and Ernst & Ernst reports. They argue first that the existence of the reports was in fact disclosed by Neil Kennedy, a partner in the law firm representing Huarisa and SKI, at the January 6, 1969, meeting in his office at which the problem of the Sun Chemical offer for the Burke stock and Huarisa's inability to exercise his option were discussed. This assertion, supported by the deposition testimony of Huarisa and Howard B. Sweig, another attorney in the law firm representing Huarisa and

SKI, is contradicted by the trial testimony of Ethington and is belied by the conduct of Ethington and Ross in rushing to New York after receiving the call from Alexander and then immediately confronting Meers with the failure to disclose the Burke and Ernst & Ernst reports.

It is not, however, necessary for this court to resolve the conflict between the testimony of Ethington and of Huarisa and Sweig, because even accepting Huarisa's and Sweig's version of the January 6 meeting, defendants' disclosure was inadequate. According to Sweig, at the end of an extensive discussion in which Kennedy belittled Burke's business judgment and his personal qualities, Kennedy stated, as a further example of Burke's irrational behavior, that Burke had retained some accountants and had complained to the SEC about SKI's financial affairs. According to defendants' version, when Ethington asked what happened at the SEC, Kennedy replied, "the SEC kicked them out of the office." This last statement does not reflect what happened, and any statement to that effect is misleading. The SEC had not kicked Burke out, but had, rather, accepted Price Waterhouse's explanation of the 1967 annual report and their assurance that they would review the propriety of continued deferrals of the CPU-46 at year end 1968, indicating, at least, that one matter was still open. Thus, even if defendants' witnesses are believed, any disclosure of the Burke and Ernst & Ernst reports on January 6, 1969, was made in a false and misleading manner and did not inform Sundstrand of the material facts.

Defendants also assert that the Burke and Ernst & Ernst reports did not need to be disclosed because the SKI board of directors and, more importantly, the SEC had considered Burke's complaints and found them groundless. As discussed above, that was not the result

of the meeting with Davies of the SEC. Moreover, all the defendants knew from the monthly financial statements that the deferred preproduction costs on the CPU-46 and other programs kept increasing after the meetings with the SEC. They also knew, from the answers to Meers' questions at board meetings, that the CPU-46 had still not qualified and was, therefore, not a candidate for any of the follow-on business necessary to amortize the mounting preproduction costs.

With these important issues not resolved, the materiality of the Burke and Ernst & Ernst reports is not open to serious question. The fact that a director of SKI and a national accounting firm had raised these questions was itself a material fact which should have been disclosed to Sundstrand. The significance of these questions was recognized by Meers and the other directors of SKI, who attended numerous meetings at which officers of SKI and representatives of Price Waterhouse took part in discussions of the issues raised by the reports. The importance of the reports is confirmed by subsequent events. In preparing the 1968 annual report, Price Waterhouse determined that the continued deferral of preproduction costs on the CPU-46 and other programs was improper, and that the losses on the CPU-46 should be written off. These matters, raised in the Burke and Ernst & Ernst reports, resulted in write-offs of several million dollars.

3. *Nine-Month Earnings Report of November 4, 1968*

SKI's quarterly report to shareholders for the nine months ended September 30, 1968, prepared on or about November 4, 1968, was false and misleading. This report, which was not audited or examined by SKI's independent certified public accountants, Price Waterhouse & Co., was not prepared in accordance with generally accepted accounting principles, nor with its own accounting policies.

Instead, the accounting policies followed in the preparation of the audited financial statements for year-end 1967 and 1968, which were reflected in SKI's annual reports for those years, were largely ignored in the preparation of the results for the nine months ended September 30, 1968.

The reported nine-month earnings of SKI and its subsidiaries included grossly inflated amounts for KIC. The report overstated earnings because of a failure to make various adjustments which would have reduced KIC's income, and because of certain "management adjustments" which increased income, and which were improper in whole or in part.

The adjustments which should have been made by KIC were in several categories: recognition of anticipated losses on contracts (cost overruns), amortization of preproduction costs, write-off of "preproduction" costs incurred where there was no related contract, write-off of improperly deferred purported "start-up" costs, and errors in costing between SKI and KIC. Had these adjustments been made, SKI would have reported 30 cents as earnings per share for the nine months ended September 30, 1968, rather than 86 cents per share. As early as July, 1968, Werle submitted a memorandum to Nichinson revealing his knowledge that a number of these adjustments were required to be made.

The particular adjustments which should have been made, and their effect on the financial results which were actually reported, are summarized in Table A at page [37].

Gerald W. Hepp, a certified public accountant, testified as an expert witness for Sundstrand on certain accounting matters, particularly with respect to the SKI report of September 30, 1968. Hepp was qualified to testify as an

expert on such matters. The opinions he expressed were based on generally accepted accounting principles, the accounting policies of KIC applicable to the preparation of SKI consolidated financial reports as reflected in SKI and KIC published reports, "representation letters" to Price Waterhouse, and other documents, rules of the Securities and Exchange Commission and New York Stock Exchange, and accounting records of SKI and KIC. Hepp examined original accounting records of KIC produced by Sun Chemical. He also considered other accounting records and working papers produced by the corporate defendant and by Price Waterhouse & Co. As a basis for his opinions, Hepp considered and relied upon the available evidence from the records of the corporate defendant as well as other evidence, and the sources he relied upon were of a type reasonably relied upon by accountants in forming opinions on accounting matters.

**TABLE A—SUMMARY OF ADJUSTMENTS WHICH SHOULD
OF STANDARD KOLLSMAN INDUSTRIES, INC.**

REFERENCE	PTX NO.	NATURE OF ADJUSTMENT
CPU-46	319	Recognition of anticipated loss on co
CPU-46	320	Amortization of preproduction costs
AAU-19	321	Recognition of anticipated loss on co
AAU-19	322	Amortization of preproduction costs
4201	323	Write-off costs incurred because of r related contract
SWING	324	Recognition of anticipated loss on co
Ordinance	325	Write-off of improperly deferred cost
VVI	326	Recognition of anticipated loss on co
M125	327	Error in costing between SKI and KIC
KS200	328	Reversal of profit improperly recorde
906262	330	Recognition of anticipated loss on co
908152	331	Recognition of anticipated loss on co
906322	332	Recognition of anticipated loss on co

TOTAL ADJUSTMENTS

Reported in Statements
Total Adjustments (See above)

Adjusted Amounts

This table is substantially taken from Plaintiff's Trial Exh
PTX316 included an adjustment of $261,816 as amortization of
that the evidence does not support plaintiff's assertion tha

HAVE BEEN REFLECTED IN FINANCIAL STATEMENTS
ND SUBSIDIARIES AT SEPTEMBER 30, 1968

	AMOUNT OF ADJUSTMENT	INCOME TAX EFFECT	NET ADJUSTMENT	PER-SHARE EFFECT
ntract	$ 324,445	$ 170,983	$ 153,462	$ .064
	369,889	194,932	174,957	.073
ntract	596,381	314,293	282,088	.118
	294,978	155,453	139,525	.059
	70,766	37,294	33,472	.014
tract	162,000	85,374	76,626	.032
	521,917	275,050	246,867	.104
ntract	188,227	99,195	89,032	.037
	147,770	77,875	69,895	.029
	44,000	23,188	20,812	.009
ntract	26,396	13,911	12,485	.005
ntract	14,114	7,439	6,675	.003
ntract	35,400	18,656	16,744	.007
	2,796,283	1,473,643	1,322,640	.56

"Earnings"	Income Tax Effect	Net Earnings	Per Sh. Net Earnings
$4,350,039	$2,293,626	$2,056,413	$ .86
2,796,283	1,473,643	1,322,640	.56
$1,553,756	$ 819,983	$ 733,773	$ .30

bit 316 (PTX 316).
preproduction costs on the KS-200. The court finds
this adjustment should have been made.

The opinions expressed by Hepp as to the adjustments which should have been made are supported by the weight of the evidence. Hepp's opinions were predicated on documents and other evidence showing facts known to the corporate defendant prior to the preparation of the nine-month report, on or about November 4, 1968. Further, these opinions are consistent with and corroborated by (a) the deposition testimony of Donald B. Chandler, the Price Waterhouse partner-in-charge of the KIC phase of the audits for year-end 1967 and 1968, (b) the trial testimony of Howard D. Murphy, the Price Waterhouse partner-in-charge of the overall audit of SKI and subsidiaries for those years, (c) memoranda prepared by Price Waterhouse in which judgments and opinions on many of the same matters were expressed, (d) documentary evidence of adjustments later made by the corporate defendant with respect to the same costs, including both year-end adjustments and the monthly amortization of preproduction costs which finally commenced in 1969, and (e) portions of the testimony of the defendant Ryan.

Other portions of Ryan's testimony were contrary to portions of Hepp's testimony. To the extent there is a conflict, the court accepts the testimony of Hepp and discounts the contrary testimony of Ryan because Ryan's contrary testimony is against the weight of the evidence, both documentary and testimonial, as will be discussed hereafter, and because Ryan is strongly identified with the interests of the defendants.

Defendants challenged the testimony of Hepp in two principal areas: first, the required date of commencement of amortization of preproduction costs on products known as the CPU-46 (a military air data computer), AAU-19 (an altimeter for use on military aircraft) and KS-200 (an air data computer for use on commercial aircraft), and second, the proper manner of determining the existence of cost overruns on contracts.

Preproduction costs are costs, consisting primarily of engineering labor and related overhead, which are incurred in the development of a product. Under generally accepted accounting principles, costs of this nature may, in some circumstances,[12] be deferred, rather than expensed as incurred, to some future time when, it is hoped, the product will be in production and earning profits which will "cover" the preproduction expenses. Where the program does not produce the expected profits, deferred costs must be amortized over a set period of time. By year-end 1967, KIC had deferred substantial preproduction costs in connection with the CPU-46, the AAU-19 and the KS-200 programs. ("Program" refers to a situation in which KIC had a contract for a particular product, and also had the expectation of additional follow-on contracts.) The amount of these costs was of such a magnitude that it was felt a formal policy for dealing with them should be adopted. SKI and KIC, in consultation with Price Waterhouse, formalized a policy which provided that, where appropriate, preproduction costs could be deferred until the first delivery date under the initial contract of the program. Beginning on that date, all deferred costs would be amortized as "covered" in equal amounts over a three-year period. Price Waterhouse emphasized that, in order to maintain accounting consistency, the date on which amortization was to begin, once set, could not be changed.

With respect to the CPU-46, the AAU-19 and the KS-200, on which some $2,500,000 of preproduction costs had been deferred by the end of 1967, the date for the first

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[12] Only a program which represents the development of a new product or a new technology and which has potential for substantial follow-on business warrants deferral of preproduction costs.

deliveries under the initial contracts on those programs had all passed by December 31, 1967. Consequently, the starting date for the three-year period of amortization of preproduction costs on those programs was set as of January 1, 1968. This policy was referred to in the SKI annual report for 1967 and was implemented by the manner in which uncovered preproduction costs were carried as assets in the balance sheet contained in that report. While two-thirds of such costs were separately shown in the balance sheet as deferred preproduction costs, the other one-third was included in "Current Assets". The amount included in "Current Assets" was to be either amortized or "covered" by follow-on contracts during 1968. It was also referred to in the 1968 KIC "representation letter" sent to Price Waterhouse in connection with the year-end audit. Ryan testified that in 1968 he understood amortization was to commence on the date of first actual delivery of the product, and that he did not know until February of 1969 that the amortization of preproduction costs on these three programs was to commence January 1, 1968. The distinction is critical because, due to late performance by SKI and changes in contract specifications, delivery of the first CPU-46 was not scheduled until some time in 1969, and delivery of the AAU-19 had not commenced until the spring of 1968. The court finds that Ryan's lack of knowledge of the proper starting date for amortization stemmed from willful and wanton negligence or a reckless disregard for the truth. Moreover, a memorandum from Werle to Nichinson in July, 1968, shows that Werle knew that January 1, 1968, was the proper starting date. After he was promoted by Huarisa in August, 1968, however, he changed his position and sought to defer the starting date to the date of first delivery of the product involved.

Hepp testified, and this court finds, that, had SKI followed the correct principles of accounting for its preproduction costs, the nine months' earnings report would have reflected the amortization of preproduction costs on the CPU-46 in the amount of $369,889 and the amortization of $294,978 of such costs on the AAU-19. In fact, there was no amortization of these costs.

Another program on which preproduction costs should have been written off as of September 30, 1968, was the 4201 airspeed indicator. According to the SKI policy on preproduction costs, deferral was proper only where there was at least one contract in hand for the product being developed. The only exception to this was where a contract was being negotiated and was virtually certain to be signed. As of the end of September, 1968, KIC had deferred $70,766 in preproduction costs on the 4201, but had no contract in hand. In August, 1968 Boeing had cancelled the only outstanding order for the 4201. No other orders were being negotiated. All of these costs should have been written off.

The accounting policy of SKI and KIC as set forth in the SKI annual reports for 1967 and 1968, and in the "representation letters" from KIC to Price Waterhouse in connection with the audits for those years, provides that the determination of whether a contract is in a cost overrun position is made on the basis of an evaluation of the contract or contracts in house, as distinguished from follow-on contracts expected or hoped to be received as a part of a program. As stated in the annual reports for those years,

> "If estimates of total contract cost indicate a loss, provision is made currently for the total loss anticipated on the contract."

There is evidence that from August, 1968, through January, 1969, *i.e.*, after Werle was promoted to report directly to Huarisa, KIC made computations of total contract costs on the CPU-46 and AAU-19 on a program basis, that is, on the assumption that additional follow-on contracts would be received and production costs per unit would thereby be lowered. By using this program basis rather than a contract-in-house basis, cost overruns were purportedly eliminated. These computations were inconsistent with the accounting policies of KIC, and to the extent they may have been used as a basis for not recognizing cost overruns or not amortizing preproduction [13] costs as of September 30, 1968, the accounting policies of KIC were simply ignored. The amount of losses on these two contracts which should have been, but were not, written off at the end of the third quarter of 1968 was $324,445 on the CPU-46 and $596,381 on the AAU-19.

A number of other losses should have been, but were not, recognized as of September 30, 1968. KIC internal accounting papers show that losses aggregating $75,910 on three contracts numbered 906,262, 908,152 and 906,322 were known prior to the release of the nine months' earnings report. The losses on these contracts were not written off. Similarly, losses on the VVI (Vertical Velocity Indicator) are shown by KIC internal documents and interrogatory answers of Sun Chemical and Huarisa to have been known prior to the preparation of the nine months' report but were not written off at that time. Hepp testified that the amount of loss which should have been recognized as of September 30 was $188,227. Though the amount

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[13] To the extent that a contract is calculated to be profitable, preproduction costs which would otherwise have to be amortized are considered "covered".

which was written off on the VVI as of year-end 1968 was only $139,304, defendants Sun Chemical and Huarisa offered no evidence to contradict Hepp's testimony, and, consequently, the court finds that in light of facts as they then existed, $188,227 should have been written off on the VVI contract as of September 30, 1968. Finally, SKI should have recognized a loss of $162,000 on the SWING contract. SKI had sustained a loss of $337,000 on this secret government program but had submitted a claim to the government to cover the loss and had, accordingly, not written off the loss. By July, 1968, at the latest, however, Werle recognized that, because of a limitation of claim agreed to by SKI, the maximum amount recoverable under the claim was $175,000, and that $162,000 would have to be written off.

Three other adjustments to the KIC books should have been made in connection with the three quarters' report. On September 30, KIC carried on its books a profit of $44,000 on the KS-200. This was improper because there were at that time uncovered, unamortized preproduction costs in that program, and according to the policy on preproduction costs, no profit could be recorded until all preproduction costs had been covered. Second, $521,917 had been deferred as "start-up costs" of the ordnance division of KIC. This division was formed by combining parts of other divisions of KIC which had ordnance-type contracts into a new ordnance-only division. Hepp testified that these "start-up" costs were simply the normal overhead and administrative expenses of an established, though expanding, line of business and not properly deferrable. Deferral of start-up costs is allowable, if at all, only when incurred in the commencement of a new line of endeavor. Hepp's opinion of the propriety of the deferral of these costs was supported by Price Waterhouse's evaluation of

these costs and their insistance that they be written off at year end. Finally, the nine months' report reflected an improperly recorded profit of $147,770 attributable to an error in costing between KIC and SKI on the M125 fuse contract. The fuses for this contract were manufactured in SKI facilities, and sold to KIC, which sold them to the government. The SKI-KIC transaction was intended to be at the same price as the KIC-government sale. The result of this would be that KIC would show zero profit or loss. By the end of August, however, a number of fuses had been sold to the government at a price higher than that which SKI had charged KIC, resulting in profit of $147,770 being wrongfully recorded at KIC. This was known by Werle and Nichinson at least as early as September 26, 1968, but no adjustment was made on the consolidated SKI books prior to the publication of the nine months' report on November 4, 1968.

In 1975, almost four years after the first trial of this case, Sun Chemical produced underlying general ledger records of KIC. In examining these records, Hepp determined that they reveal pre-tax profit of KIC for the first nine months of 1968 in an amount $2,445,000 less than the KIC figure included in the consolidated financial results of SKI's September 30, 1968, quarterly report. In response to Hepp's request for further information, Sun Chemical produced a document which indicates that the pre-tax profit of KIC for that nine-month period was deliberately increased by $2,445,000 over the amount reflected in the general ledger accounts of KIC. Subsequent discovery revealed only one handwritten document, labeled "KIC Summary of Management Adjustments to P & L 1968" (Summary of Adjustments), which purports to support the $2½ million increase in income. Each of the

adjustments in the various items set forth in this document had the effect of *increasing* income. If this $2½ million write-up had *not* been made, and the other adjustments referred to, *supra, had* been made, SKI's results for September 30, 1968, would have been reported as a *loss* of $1,153,000 before taxes, or a *loss* of 18 cents per share after taxes, rather than the $4,350,000 or 86 cents per share in *earnings* which were actually reported.

Hepp did not go so far as to render an opinion that these "management adjustments" were improper. He testified on cross-examination that adjustments of this general nature are sometimes made by business firms during the course of a year on the basis of accountants' working papers and are not recorded in the general ledger accounts until year-end. In addition, defendants Sun Chemical and Huarisa offered a group of exhibits which they contend show year-end 1968 entries in accounts referred to on the Summary of Adjustments, in support of their contention that the management adjustments at September 30, 1968, were proper. Some of these exhibits were identified and explained during the cross-examination of Hepp, but others have not been identified or explained by any witness. Indeed, defendants presented no testimony whatsoever with respect to these "management adjustments". In an interrogatory answer purporting to explain the adjustments shown on the Summary, Sun Chemical and Huarisa stated that the $2,445,000 management adjustments were later reduced and "resulted in a year-end book entry on the KIC general ledgers of $1,525,075."

Based upon all the evidence, the court finds that even if the "management adjustments" included in the September 30, 1968, KIC financial statement were in part proper, at least the difference between the amount booked at year-end and the amount as of September 30, 1968, ap-

proximately $920,000, had no proper purpose and was made in a deliberate effort to increase the reported earnings of SKI and its subsidiaries for the nine-month period ending September 30, 1968. This finding is supported by the following facts: (a) The Summary of Adjustments contains no detail for the management adjustments to individual accounts for the month of September, 1968, although such detail is provided for August and earlier months; (b) the very existence of the management adjustments was revealed only after years of the persistent discovery efforts of plaintiff, and the more recent thorough investigation by Hepp; and (c) Werle, the man specially promoted by Huarisa in August, 1968 to find "a couple of million dollars more of KIC income" in 1968, was responsible for the KIC financial statement in question. (d) Neither Werle nor anyone else presented any testimony as to the reasons for these adjustments, all of which resulted in reporting higher SKI earnings. In the context of the other misrepresentations in the nine months' report and the negotiations with Sundstrand, these factors compel the conclusion that these adjustments were deliberately overstated.

If management adjustments in the amount of $920,000 had not been made as of September 30, 1968, SKI's reported earnings per share would have been reduced by 18 cents. Thus, taking into account the downward adjustments which should have been made, and the management inflated adjustments which should not have been made, the court finds that SKI should have reported earnings of approximately 12 cents per share for the nine months ended September 30, 1968, rather than 86 cents per share. The court further finds that Ryan and Werle knew of the falsity of the earnings reported by SKI for the nine months ended September 30, 1968.

In August 1969, Sun Chemical, then a stockholder of SKI, filed suit against SKI, Huarisa, Ryan and others, charging the defendants with violation of Rule 10b-5 on the ground, among others, that SKI's September 30, 1968, quarterly report to its shareholders was false and misleading. In April 1970, Sun Chemical, still a SKI shareholder, joined as an additional named plaintiff in a class action that had been initiated by another SKI stockholder against SKI and Price Waterhouse, likewise charging defendants with violation of Rule 10b-5. The complaint joined in by Sun Chemical not only alleged that SKI's September 30, 1968, quarterly report to its shareholders was false and misleading, but also that members of the plaintiff class—which included Sundstrand—had suffered substantial injury as a result of the wrongs complained of. At the same time that Sun Chemical joined the class action, its individual suit was voluntarily dismissed, and Huarisa and Ryan were thereby dropped as defendants. At about the same time, Alexander, president of Sun Chemical, joined the SKI board. Although Sun Chemical remained a plaintiff in the class litigation, as successor to SKI, it paid $250,000 in final settlement of the case in May 1975, long after its December 1972 merger with SKI.

Unaudited interim statements of earnings reported to investors are required by the federal securities laws to meet the same standards of truthfulness and adequate disclosure as are required for audited annual reports, *Kaiser-Frazer Corp.* v. *Otis & Co.*, 195 F.2d 838 (2d Cir. 1952), *cert. denied*, 344 U.S. 856 (1952); *SEC* v. *Keller Indus., Inc.*, 342 F.Supp. 654 (S.D. N.Y. 1972). A reasonable investor undoubtedly might attach importance to such reports in making an investment decision.

It was on these misrepresentations and nondisclosures made during the preliminary negotiations and in the nine months' earnings report that Sundstrand relied when it entered into the January 9, 1968, agreement and transferred to Huarisa the 5,686 shares of Sundstrand common stock. Between January 9 and the purchase of the 223,190 shares of SKI stock by Sundstrand on February 6, Sundstrand conducted an investigation of SKI, described above. This investigation, however, did not cure the previous misrepresentations and omissions. In fact, defendants' previous misrepresentations were reiterated and their statements were amplified by further material false representations and omissions.

B. Material Misrepresentations and Omissions Between January 9 and February 6, 1969

1. Price Waterhouse & Co. Audit

During January, 1969, SKI personnel were conferring with Price Waterhouse & Co., SKI's independent public accountants, with reference to adjustments which would have to be made on the books of SKI.[14] Adjustments in the magnitude of several million dollars were then being considered. On January 15, 1969, John Martin, Werle's staff assistant, informed Nichinson, then president and a director of KIC and vice president of SKI, that, in the

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[14] The assessment of Price Waterhouse was of utmost importance in determining the true state of the financial condition of SKI. SKI was required by regulations of the Securities and Exchange Commission to obtain a certificate from independent public accountants with respect to its year-end financial statements (see SEC Regulation S-X, 17 CFR 210 as in effect at the time relevant to this case), and the financial statements in the SKI annual reports to shareholders had regularly been audited and certified by Price Waterhouse for a number of years.

course of the Price Waterhouse year-end audit, write-offs of certain costs on the books of KIC were being considered. These write-offs were far in excess of the amount stated to Sundstrand by Ryan and Werle as the "maximum" write-off of preproduction costs and involved other types of substantial costs. On January 20, 1969, Nichinson had a phone conversation with Donald Chandler, the Price Waterhouse partner-in-charge of the KIC phase of the SKI audit. Chandler discussed the areas of adjustment being considered and acknowledged that KIC write-offs on the order of perhaps $2,000,000 to $2,500,000 were under consideration.

Several days prior to Sundstrand's cash payment of $6,360,915 for the SKI stock on February 6, 1969, Ryan and Werle received a memorandum from Price Waterhouse stating its preliminary assessment that write-offs in the range of $3,000,000 to $4,500,000 would have to be made on the books of KIC as of year-end 1968. Write-offs of such magnitude would have had the effect of reducing SKI's after tax earnings by about $.60 to $.90 per share—compared to per share earnings of $.86 reported for the first nine months and compared to the $1.16 figure for the full year which had been given to Sundstrand. Huarisa knew of this assessment before February 6.

Price Waterhouse prepared its memorandum between January 20 and 27, 1969. The consideration of many of these write-offs had commenced long before—as early as October, 1968, when Price Waterhouse started its annual audit work for SKI and its subsidiaries. The evidence establishes that Huarisa, Ryan, Werle, SKI and KIC knew or should have known of Price Waterhouse's views at least by the time of the survey meetings with Sundstrand earlier in January. This finding is further supported by the fol-

lowing: (a) Nichinson was able to obtain such information even though his position as president of KIC was beclouded by the earlier announcement of his purported "resignation"; (b) the Price Waterhouse audit team had been working in the KIC offices and consulting with KIC management for some four months prior to the preparation of the memorandum; and (c) the need for many of these write-offs had been evident by the time of the publication of the report for the first nine months of 1968.

The assessment in the memorandum was a material fact which should have been disclosed to Sundstrand prior to its payment of $6,360,915 in cash for the SKI stock on February 6, 1969. Defendants had a duty, prior to the time Sundstrand made its payment on February 6, 1969, for the SKI stock, to advise Sundstrand of any facts they learned which tended to show that statements they previously made were not true when made or were no longer true. *Fisher* v. *Kletz,* 266 F.Supp. 180 (S.D. N.Y. 1967); *Butler Aviation Inter. Inc.* v. *Comprehensive Designers, Inc,* 307 F. Supp. 910, 913 (S.D.N.Y. 1969), *aff'd,* 425 F.2d 842 (2d Cir. 1970); *SEC* v. *Shattuck Denn Mining Corp.,* 297 F.Supp. 470, 476 (S.D.N.Y. 1968); *Restatement of Torts,* §441(2); Prosser, *Law of Torts,* §106, pp. 696-97 (4th ed. 1971).

The fact that the memorandum contained preliminary assessments rather than final conclusions did not vitiate this duty of disclosure. The memorandum concerned a number of issues, such as the treatment of preproduction costs on the CPU-46, the AAU-19 and the KS-200, the profitability of these and other long-term contracts and the value of certain inventories, about which Sundstrand had asked particular questions and SKI had made specific representations, most of which were contradicted by the

Price Waterhouse memorandum. In these circumstances, the preliminary nature of the memorandum did not affect its materiality or the duty to disclose it. This duty was not met. Sundstrand first learned of this assessment in pretrial discovery in this case when it was produced by Price Waterhouse. The document was never produced by SKI.

Significantly, the Price Waterhouse assessment was an accurate evaluation of the amount of write-offs actually required. Adjustments, including "start-up" costs and cost overruns as well as deferred preproduction costs, of more than $4,600,000—five times the "maximum" stated by SKI to Sundstrand—were charged on the books of KIC as of year-end 1968 and were the principal reason for the disastrous financial results ultimately reported for 1968. When Ryan explained these results to the SKI board of directors in March, 1969, he discussed the major items written off. Each of these items had been mentioned as a candidate for write-off in the Price Waterhouse assessment. Nearly half of this amount consisted of write-offs of items other than preproduction costs, which items had not been mentioned at all during the January meetings with Sundstrand.

2. Other Misrepresentations

In addition to the failure to disclose the Price Waterhouse evaluation and the continued false and misleading statements as to SKI's 1968 and 1969 earnings and the profitability of the Avionics Division, other statements made by Huarisa and SKI during the period from Sundstrand's purchase of the SKI stock, January 9, 1969, to its cash payment therefor, February 6, 1969, were false

and misleading in numerous respects. These misrepresentations and omissions, described below, pertained to write-offs which were in fact made at year-end 1968, in the total amount of more than $4,625,000, or 92 cents per share after taxes. All of these misrepresentations and omissions were material.

CPU-46

As of year-end 1968, KIC wrote off $2,015,000 of preproduction and production costs in connection with the CPU-46. This sum was the total of the following costs:

Preproduction costs incurred through December 31, 1968	$1,540,911
Estimated preproduction costs to be incurred thereafter	214,000
Anticipated loss on production contract	260,089
Total	$2,015,000

The CPU-46 write-off was taken for the following reasons:

(a) Despite the long period since the initial contract was made, KIC had still not completed the tests required by the government to demonstrate acceptability of the product, and the time for such completion continued to be unknown. Successful completion of these tests was required before deliveries could be made under the contract, and also before KIC could attain status on the government's Qualified Products List ("QPL"), which was considered a prerequisite to KIC's ability to obtain any follow-on business.

(b) KIC's estimates of the market potential for this product, even if it should obtain follow-on business, were inflated out of all relation to the government's real needs.

(c) Without even considering preproduction costs, KIC could not produce the CPU-46 at a cost which would yield a profit on the contract-in-house. There was no evidence that units covered by subsequent follow-on contracts —even if such contracts could be obtained—could be produced at a profit.

Defendants contend that the "decision" to write off the CPU-46 costs was made in March, 1969. During the period January 9 to February 6, 1969, however, defendants had knowledge of all the facts on which the "decision" was ultimately based. In fact, the reasons given for this "decision" were essentially the same ones expressed by Burke and Ernst & Ernst in the spring and summer of 1968 in questioning the CPU-46 accounting treatment.

During that period of time, defendants made the following material misrepresentations and omissions to Sundstrand with respect to the CPU-46:

(a) Representation that final government approval on the CPU-46 was imminent and would be obtained almost any day. Defendants knew or should have known that such approval could not be obtained before the summer of 1969. Such approval was not, in fact, forthcoming until September, 1969.

(b) Representation that the total market potential for the CPU-46 was at least 8,000 units. In fact, the government's total program requirement—the total number of units expected by the government to be ultimately procured and not yet contracted for—was 2,619 units. Katz obtained this information from the government officer in charge of CPU-46 procurement in November, 1968, and relayed it at that time to Werle and other KIC personnel.

(c) Representations that the maximum amount of preproduction costs KIC could possibly have to write off on the CPU-46 at year-end 1968 was $526,000 and that the contract-in-house was profitable. In fact, at year-end 1968 KIC wrote off $1,755,000 of preproduction costs and $260,000 as a cost over-run on the CPU-46.

Preproduction Costs on the AAU-19

As of year-end 1968, KIC wrote off one-third of the preproduction costs incurred in connection with the AAU-19, in the sum of $408,000.

Although Ryan and Werle knew that KIC's accounting policy required such write-offs, they did not disclose this fact to Sundstrand. To the contrary, Ryan and Werle falsely stated to Sundstrand on January 16, 1969, that the maximum amount of such costs KIC could possibly have to write off on the AAU-19 was $72,000.

Obsolescent Inventory

As of year-end 1968, KIC wrote off against income $379,168 to provide an adequate reserve for obsolete inventory in the Avionics Division; $362,758 of this amount was attributable to a write-off of obsolescent guidance spare parts inventory, otherwise known as "cost center 855". Price Waterhouse, during December, 1968 and January, 1969, was specifically questioning, with KIC, the propriety of carrying this virtually dead inventory on KIC's books. Nevertheless, on January 9 and January 16, 1969, Ryan and Werle falsely stated to Sundstrand that the inventory reserve of about $180,000 was adequate and would be sufficient to cover any obsolescence of inventory.

Ordnance Start-up Costs

As of year-end 1968, KIC wrote off the so-called ordnance "start-up" costs, in the sum of $522,000, which should have been written off as of September 30, 1968. No mention of these costs had been made to Sundstrand.

Losses Determined from Review of Status of Contracts, Including Estimated Cost to Complete

KIC wrote off a total of $1,298,239 in excess production costs on contracts, reflecting losses incurred and/or anticipated under some nine long-term contracts. The contracts and amounts of these costs are as follows:

CPU-46	$ 260,089[15]
SWING	224,083
VVI	221,067
AAU-19	181,000
KS-208	112,000
L.L.L. TV	94,000[16]
SPARS	86,000
IRU	70,000
SPERRY	50,000
Total	$1,298,239

As a result of contract status reports prepared monthly in some KIC divisions and quarterly in others, SKI knew during and even long before January, 1969 that the production cost on at least seven of these contracts, CPU-46, SWING, VVI, AAU-19, KS-208, L.L.L. TV and IRU,

[15] Also referred to under the heading *CPU-46,* supra.

[16] In this instance KIC reversed this amount of previously recorded estimated profits, due to a revaluation indicating break-even at completion of the contract.

was in excess of the contract recovery by approximately the amounts written off at year-end, but did not advise Sundstrand of any of these excess costs. In fact, Werle falsely informed Sundstrand that the AAU-19 contract or contracts were profitable.

Further the representations regarding quarterly KIC reviews of long-term contracts, the write-off of losses disclosed by such reviews, and $600,000 written off for the month of November, 1968 were false and misleading. Although Contract Status Reports were prepared by divisional personnel at KIC on a monthly or quarterly basis, the corporate accounting personnel of KIC ignored cost overruns shown by these Contract Status Reports and did not write off any of these losses during 1968. Where estimates to complete made during 1968 showed a contract loss, KIC did *not* write off the loss but instead continued to carry the excess costs on its books. Neither $600,000 nor any other sum was written off in November, 1968 as the result of any contract review.

Defendants argue that even if there were misrepresentations made of facts not disclosed to Sundstrand prior to January 9, which they deny, there can be no liability because Sundstrand was given free access to all relevant data during its survey of SKI and should have discovered the true facts of SKI's financial condition. This assertion is without merit. Its principal flaw is that with respect to financial information, the type of information most important to this lawsuit, Sundstrand did not, in fact, have unfettered access to information about SKI. In fact, rather than provide Sundstrand with access to the truth about SKI's financial condition, SKI and Huarisa used the survey to make the further misrepresentations discussed above.

Further, even if Huarisa and SKI had allowed Sundstrand free access to SKI's records, they would have no valid defense. With respect to omissions, the duty to "state all material facts necessary to make other statements not misleading . . . is not discharged merely by giving the purchaser access to company records and letting him piece together the material facts if he can." *Metro-Goldwyn-Mayer, Inc.* v. *Ross,* 509 F.2d 930, 933 (2d Cir. 1975). Moreover, the duty is no different where the investor is supposedly sophisticated. *Stier* v. *Smith,* 473 F. 2d 1205, 1207 (5th Cir. 1973). With respect to misrepresentations, the Seventh Circuit has recently held that, "[it is not] material, short of a showing of actual knowledge of the fraud, what knowledge any plaintiff had about [the defendant]." *Sanders* v. *John Nuveen & Co., Inc.,* 524 F. 2d 1064, 1073 (7th Cir. 1975). There is no evidence whatsoever that Sundstrand had actual knowledge of the fraud being perpetrated upon it.

Causation

In order to prevail in an action under Rule 10b-5, plaintiff must show not only that the defendant engaged in wrongful conduct, but also that the conduct caused him injury. This is generally done by establishing reliance upon the misrepresentations or omissions of defendant. Where the misconduct alleged is a failure to disclose,

> ". . . positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. [Citations omitted.] This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact." *Affiliated Ute Citizens of Utah* v. *United States, supra,* at 153-54.

See also *Northway, Inc.* v. *TSC Industries, Inc.*, 512 F.2d 324, 331 (7th Cir.), *cert. granted* 44 U.S.L.W. 3180 (Oct. 6, 1975). Where misrepresentations are alleged, the test of reliance is whether " 'the misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss' ", *List* v. *Fashion Park, Inc.*, *supra*, at 462.[17]

The court finds that Sundstrand's proof clearly establishes that it relied on all of the misrepresentations and omissions discussed above. The Burke and Ernst & Ernst reports and the Price Waterhouse memorandum were material, and no other reliance need be shown. The affirmative misrepresentations concerned matters crucial to the determination of terms of any merger—present and future earnings—and about which Sundstrand had shown concern from the beginning of the negotiations. Ethington gave direct testimony at trial that Sundstrand relied on SKI's and Huarisa's representations about SKI's earnings in the purchase of the stock. The court finds further that Sundstrand's reliance was entirely reasonable.[18]

Standard of Duty

The final element of plaintiff's case is a showing that the defendants acted, or failed to act, with a mental state for which liability can be imposed. It has been held by this Circuit that a 10b-5 plaintiff need not prove the *scienter*

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[17] Some courts have questioned whether even this much need be shown where the facts misrepresented are material. See *e.g.*, *Janigan* v. *Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied* 382 U.S. 879 (1965); *Reeder* v. *Mastercraft Electronics Corp.*, 363 F.Supp. 574 (S.D.N.Y. 1973).

[18] From *Sanders* v. *Nuveen*, *supra*, it appears that reasonableness need not be shown, as long as plaintiff did not actually know of the fraud.

required for a common law action for fraud based on intent or recklessness. In *Tomera* v. *Galt,* 511 F.2d 504, 508 (7th Cir. 1975), the court said "Rule 10b-5 claimants need not plead nor prove scienter." That is, a plaintiff can recover for negligent, as well as intentional or reckless, misrepresentations or omissions. See also *Parrent* v. *Midwest Rug Mills, Inc.,* 455 F.2d 123 (7th Cir. 1972), *Vanderboom* v. *Sexton,* 422 F.2d 1233 (8th Cir. 1970), and *Ellis* v. *Carter,* 291 F.2d 270 (9th Cir. 1961). But see *Lanza* v. *Drexel & Co.,* 479 F.2d 1277 (2d Cir. 1973). Subsequent to *Tomera* the Court of Appeals for the Seventh Circuit has indicated that rather than a single standard, there may be a flexible standard of duty to disclose and investigate the truth of representations which depends upon the details of the particular business relationship. *Sanders* v. *John Nuveen & Co., Inc., supra,* at 1069, n. 13-15. See also *Kohler* v. *Kohler Co.,* 319 F.2d 634, 637-38 (7th Cir. 1963). A flexible duty standard under Rule 10b-5 has been embraced by the Ninth Circuit in *White* v. *Abrams,* 495 F. 2d 724 (9th Cir. 1974), and by several commentators. 2 A. Bromberg, *Securities Laws: Fraud,* §8.4 (513) at 204.115 (1971), Bucklo, *Scienter and Rule 10b-5,* 67 Nw.U.L.Rev. 562, 595, n. 179. A flexible standard is a recognition of the fact that securities transactions come in so many varied contexts, and the participants in those transactions have so many and such widely varying relationships to each other, that no single standard can accomplish the purposes of Rule 10b-5 in all cases.

> "Instead of perpetuating the practice of discussing scienter and negligence as absolutes which are capable of being objectively applied, more is gained by recognizing that there is a sliding scale which determines what constitutes sufficiently diligent conduct to avoid

> 10b-5 liability, and that 10b-5 liability is determinable only within the context of the vagaries of the specific facts presented. *Mann, Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter,* 45 N.Y.U.L.Rev. 1206, 1209 (1970).

In light of *Nuveen, supra,* and because the relationship of defendant Meers to the other parties in this lawsuit is rather unusual, this court concludes that a flexible duty standard is appropriate in this case. Thus, the duty question, and the ultimate question of liability, must be considered separately for each defendant.

Liability of the Defendants

A. Liability of Huarisa

Huarisa, because of his position as a director and as chief executive officer of SKI, and because of the enormous profit which he stood to make if the merger between Sundstrand and SKI was consummated, was under a strict duty to investigate the truth of the representations which he and other officers of SKI made to Sundstrand and to insure that no material facts were not disclosed. However, it is not necessary to consider at length the precise nature of Huarisa's duty, because it is the conclusion of the court that he deliberately, or, at best, recklessly, misrepresented SKI's nine months' earnings, SKI's earnings for 1968 and for 1969, the interest of other companies in acquiring SKI at a price of $45 and the amount of potential write-offs of deferred preproduction costs for 1968. Huarisa also deliberately, or recklessly, failed to disclose the existence of the Burke and Ernst & Ernst reports, the Price Waterhouse memorandum of January 27, 1969, and the need for write-offs because of losses on contracts at year-end 1968.

The court also finds that Huarisa was in a conspiracy with SKI in making these misrepresentations. Huarisa and other officers of SKI, Ryan and Werle in particular, acted in concert to prevent Sundstrand from discovering the true financial condition of the corporation. Thus, Huarisa is also responsible, as a co-conspirator, for the misrepresentations already discussed made by Ryan, Werle and other SKI personnel during the Sundstrand survey of SKI and the meeting on January 22. These misrepresentations were also made intentionally or recklessly. Huarisa is also responsible for these statements of SKI personnel by virtue of the fact that he was a controlling person of SKI for the purposes of Section 20(a) of the 1934 Act, 15 U.S.C. §78t(a),[19] and as such is liable for the actions of SKI. *SEC* v. *First Securities Co. of Chgo.*, 463 F.2d 981 (7th Cir.), *cert. denied* 409 U.S. 880 (1972); *Dyer* v. *Eastern Trust and Banking Co.*, 336 F.Supp. 890, 915 (D.Me. 1971). SKI, of course, can act only through its personnel, and the actions of such personnel on behalf of SKI are taken to be the actions of SKI. *Affiliated Ute Citizens of Utah* v. *United States, supra,* at 154.

In sum, because Huarisa, and others for whose conduct he is liable, intentionally or recklessly made material misrepresentations and failed to disclose material facts in connection with Sundstrand's purchase of the Burkes' 223,190 shares of SKI common stock, Huarisa is liable to Sundstrand for the damages which it suffered as a consequence of that transaction.

B. Liability of Sun Chemical

Sun Chemical is the successor to the liability of SKI. As such it is liable for the misrepresentations and omissions of Huarisa. It is also liable because SKI individual-

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[19] See *supra* at pp. 70.

ly violated Rule 10b-5 through the acts of Huarisa, Ryan, Werle and other SKI personnel on its behalf. *Affiliated Ute Citizens, supra,* at 154.

C. Liability of Meers

The determination of Meers' liability requires an examination of his relationship to the other parties in this suit and to the transaction at issue. To begin with, Meers was a director of SKI. As such he was privy to information not available to the public or to Sundstrand and was able, if he wished, to make inquiries into areas about which he had questions. He and his fellow directors were also, of course, ultimately responsible for the conduct of SKI's affairs. Meers was also acting as an investment banker for SKI and Huarisa in this transaction. He set up the initial contact between Sundstrand and SKI, arranged further meetings and conducted the negotiations which led to Sundstrand's offer. It was understood by both Meers and SKI that these services were not those of a director and that he and his firm would receive a substantial fee if the merger were completed. Finally, Meers and his firm had a continuing business relationship with Sundstrand. White, Weld had performed investment banking services for Sundstrand in the recent past and the firms maintained business contacts until the decline in the value of SKI stock and the revelation of the Burke and Ernst & Ernst reports understandably soured the relationship. As investment banker to Sundstrand, Meers had the confidence of Sundstrand. Sundstrand also understood that Meers and White, Weld were to receive a fee if the merger went through.

In effect, Meers was on both sides and in the middle of the transaction. He had a position of influence in, and had access to information from SKI, he had the confidence of Sundstrand, and he had a pecuniary interest, as the man

who set up the deal, in making certain that the merger would go through. Each of these positions imposed a duty of disclosure on Meers. The combination of these somewhat conflicting relationships created a strong duty not only to disclose the facts which he knew, but to make a reasonably diligent investigation to determine that the representations which he and others were making were true and that no material facts remained undisclosed.

Meers breached this duty by failing to disclose the existence of the Burke and Ernst & Ernst reports and the questions that they raised about SKI's treatment of preproduction costs in general and their treatment of those costs in connection with the CPU-46 in particular. Meers' argument that the reports did not need to be disclosed is without merit. Without question, the discussions at board meetings and with the SEC clearly pointed out the importance of proper future treatment of preproduction costs. From the information which he received as a director, Meers knew that the deferral of costs on the CPU-46 and other programs was continuing and that, despite repeated assurances that qualification for government contracts was imminent, the CPU-46 had not in fact been qualified. Thus, Meers was on notice that one of the principal problems raised in the Burke and Ernst & Ernst reports was not resolved and was, in fact, becoming more severe. Given this knowledge, and the knowledge that Sundstrand had not been apprised of the Burke and Ernst & Ernst reports, Meers was under a duty to disclose to Sundstrand the existence of the reports and the persistence of the problem and to investigate the propriety of continued deferral of preproduction costs, particularly when such an investigation would have revealed that several million dollars of preproduction costs were being deferred in violation of SKI's policy for the treatment of such costs.

Meers failed to disclose these material facts which he was under a duty to disclose, and because of this, he is liable to Sundstrand for the damages suffered in connection with its purchase of the Burke stock.

Meers is also liable as an aider and abettor of Huarisa and SKI. A person is liable as an aider and abettor of a violation of the securities laws where he,

> "... had knowledge of or, *but for a breach of duty of inquiry, should have had knowledge of the fraud,* and ... possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure." (Emphasis supplied.) *Hochfelder* v. *Midwest Stock Exchange,* 503 F.2d 364, 374 (7th Cir. 1974).

As discussed above, Meers had a duty of inquiry which he breached. Had he inquired into the propriety of SKI's treatment of preproduction costs, he would have discovered that they were being carried on the books without the amortization required by the accounting policy stated in the 1967 annual reports and in the 1967 KIC representation letter. He would also have discovered that if these costs had been properly accounted for, SKI's nine months' earnings for 1968 and the projections for all of 1968 would have been drastically lower. Had he discovered these things, he would have had a duty to disclose them.

Finally, Meers is liable for the wrongdoing of SKI as a "controlling person" of that corporation. Section 20(a) of the 1934 Act, 15 U.S.C. §78t(a), provides:

> "(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person

> to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

A number of cases have held that a person "controls" a corporation simply by being an active director. *Moerman* v. *Zipco, Inc.*, 302 F.Supp. 439, 447 (E.D.N.Y. 1969); *Dyer* v. *Eastern Trust & Banking Co.*, 336 F.Supp. 890, 915 (D. Me. 1971). Other cases have required a showing that the person allegedly in control in fact exercised some control and was, to some extent, involved in the transaction at issue. *Mader* v. *Armel*, 461 F.2d 1123, 1125 (6th Cir. 1972); *cf. Strong* v. *France*, 474 F.2d 747, 752 (9th Cir. 1973); *Sennott* v. *Rodman & Renshaw*, 474 F.2d 32 (7th Cir. 1973). The court finds that under either standard, Meers was a controlling person of SKI with respect to this transaction. Meers was not just one of many co-equal directors. SKI had only six directors, and two of them, Burke and Perry Addleman, were in disagreement with Huarisa and the rest of the board. Moreover, Meers took an active part in the merger negotiations and in the board's consideration of the proposal. Meers consulted with Huarisa about what merger terms would be acceptable to the board and negotiated the terms of the proposal as Huarisa's agent. When the Sundstrand proposal was submitted to the board, Meers took part in a discussion of its terms and in a discussion of what representations had been made to Sundstrand.

As a controlling person, Meers is liable for the acts of SKI unless he can show that he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." He did not make this showing. The Seventh Circuit has said that

> ". . . 'to satisfy the requirement of good faith [in order for a controlling person to avoid liability thereby] it is necessary for the [controlling person] to show that some precautionary steps were taken to prevent the injury suffered,' Lorenz v. Watson, 258 F.Supp. 724, 732 . . ." *SEC* v. *First Securities Co. of Chicago,* 463 F.2d 981, 987 (7th Cir.), *cert. denied* 409 U.S. 880 (1972);

and that

> " 'failure of the controlling person to maintain and diligently enforce a proper system of internal supervision and control constitutes participation in the misconduct and the violation will be deemed to have been committed, not only by the controlled person, but also by the controlling person who did not perform the duty to prevent it.' Hecht v. Harris, Upham & Co., 283 F.Supp. 417, 438 . . ." *First Securities, supra,* at 987.

Meers' failure to inquire into the treatment of preproduction costs and the representations concerning those costs which were being made to Sundstrand despite his knowledge of the Burke report and the increasing amounts of deferred costs deprives him of a good faith defense to liability.

Meers is not liable as a conspirator. While the evidence showed that he failed to meet his duties of inquiry and disclosure, plaintiff failed to adduce any direct evidence of agreement or concerted action between Meers and SKI and Huarisa and the circumstantial evidence is insufficient to support a conclusion that such an agreement existed.

Sundstrand's Damages

Sundstrand purchased the Burke stock for $6,695,700, or $30 per share for 223,190 shares. After it learned of the financial results of SKI for the year 1968 and of the Burke and Ernst & Ernst reports, Sundstrand sought to dispose of its SKI shares. Meers and Huarisa, who were looking for a buyer for SKI, and Ethington had a number of conversations regarding companies which might merge with or acquire SKI. During these conversations, Ethington reiterated his desire to liquidate Sundstrand's SKI holdings and to participate in any transaction that would serve this purpose. At this same time, Sundstrand representatives talked with at least one other potential buyer and several securities brokers with regard to the possible sale of Sundstrand's SKI shares. They also met and talked with representatives of Sun Chemical during this period.

When it became apparent that no merger was imminent, Sundstrand considered selling its stock to the public. Because Sundstrand had acquired its stock from either the Burkes or from Huarisa, who were controlling persons of SKI, in a transaction which was not registered under the Securities Act of 1933, as amended, this could not be done without either obtaining a "no action" letter from the SEC or registering the stock. The stock was never registered. In June, 1969, Sundstrand requested a "no action" letter from the SEC. In July the SEC declined, stating that it was unable to conclude that the shares could be sold on the market without registration. In August, 1970, Sundstrand once more unsuccessfully requested a "no action" letter from the SEC. In December, 1972, in connection with the merger of SKI into Sun Chemical, Sundstrand could have sold the stock by dissenting from the proposed merger and perfecting its appraisal rights.

One shareholder who did this received $4.25 per share, the closing price of SKI on the New York Stock Exchange just before the merger. Sundstrand chose not to sell its stock and received 49,597 shares of Sun Chemical Corporation common stock in exchange for its SKI stock. This stock was sold on December 16, 1975, while this case was under advisement.

The objective of the private action under Rule 10b-5 is to compensate the plaintiff for the losses he has suffered because of defendant's fraud or actionable misconduct. The proper measure of Sundstrand's damages in this case is the difference between what it paid for the Burke stock and what it was actually worth. *Estate Counseling Service* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10th Cir. 1962); *Ross* v. *Licht*, 263 F.Supp. 395, 410 (S.D.N.Y. 1967); see generally, 6 Loss, *Securities Regulation*, 3922-23 (1969 Supp.). In determining the actual value of the stock,

> "Absent market value, . . . fair value is to be determined from all the pertinent circumstances both for a reasonable time before the sale and after it. . . . If there can be no exact calculation . . . the wrongdoer cannot complain if a reasonable approximation is reached'." *Ross* v. *Licht, supra*, at 410.

In this case, an exact calculation of the actual value of the SKI stock is not possible. At the time Sundstrand purchased the stock, of course, the market price of SKI stock was inflated far above its actual value because the public was unaware of SKI's true financial condition. The stock did not, however, assume its true value immediately upon the revelation of SKI's actual earnings—a loss of $.15 per share—for the year 1968. George K. Hendrick, an invest-

ment banker called as an expert witness by Sundstrand, testified that the market frequently takes quite a while to digest news such as SKI's 1968 earnings.

A further difficulty in assessing the true value of the stock comes from the fact that it was unregistered. Hendrick testified without contradiction that because of this, in combination with the size of the block and SKI's poor earnings, any private placement of Sundstrand's SKI stock during 1969 or 1970 would have had to be at a price 30% to 50% below the price of SKI shares traded on the New York Stock Exchange.

The court finds that the relevant time for the purposes of determining the value of Sundstrand's SKI stock is July, 1969. By that time the market had had several months to digest the news of SKI's 1968 earnings. Further, by that time Sundstrand could no longer reasonably hold onto the stock and be compensated by defendants for its further losses. Prior to that time, Sundstrand's efforts to dispose of the stock through a merger or to get a "no action" letter from the SEC were the most reasonable actions to mitigate its damages. After it received the SEC's denial of its request for a "no action" letter, it was apparent to Sundstrand that the only means of disposing of the stock would be by a private placement, to a buyer who would accept the restrictions attendant upon unregistered stock. It should have made such a placement.

The court further finds that the value of Sundstrand's stock at the time was the market value less 40%, which is the discount applicable to a block of unregistered stock of this size. The market price has been computed by taking the average closing price of SKI stock on the New York Stock Exchange during the month of July, 1969.

Thus, Sundstrand's damages are:

Price paid		$6,695,700
Less value of stock:		
Average closing price per share in July, 1969	$ 16.89	
Less 40% (16.89 x .40 = 6.76)	6.76	
	$10.13	
Times number of shares x	223,190	2,260,914
		$4,434,786

Sundstrand is entitled to pre-judgment interest.

Swanson v. *American Consumer Indus., Inc.*, 475 F.2d 516, 521 (7th Cir. 1973); *Madigan, Inc.* v. *Goodman*, 498 F.2d 233, 240 (7th Cir. 1974.) Sundstrand is therefore also entitled to interest on the amount of such damages from February 6, 1969, to this date, at the rate of 6 percent per annum. *Cant* v. *A. G. Becker & Co., Inc.*, 379 F.Supp. 972, 974-75 (N.D. Ill. 1974); Ill.Rev.Stat., ch. 74, §3.

Counterclaim

Since Sundstrand has proved that its agreement with Huarisa dated January 9, 1969, was made in violation of the Securities Exchange Act of 1934, the agreement is void, 15 U.S.C. §78cc(b), and Huarisa is not entitled to any relief on his counterclaim. *Sundstrand Corp.* v. *Standard Kollsman Industries, Inc., supra,* at 816. Judgment will be entered dismissing Huarisa's counterclaim.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

SUNDSTRAND CORPORATION,

Plaintiff,

vs.

SUN CHEMICAL CORPORATION, et al.,

Defendants.

NO. 69 C 1660

JUDGMENT ORDER

IT IS ORDERED that judgment is entered in favor of the plaintiff, Sundstrand Corporation, and against the defendants, Sun Chemical Corporation, Raymond F. Ryan and Thomas B. Hart, Jr., Co-Executors of the Estate of John B. Huarisa, and Henry W. Meers, in the amount of $4,434,786, together with interest at the rate of 6% per annum from February 6, 1969, to the date of this order; and FURTHER ORDERED that the counterclaim filed by John B. Huarisa is hereby dismissed.

ENTER:

/s/ Bernard M. Decker
United States District Judge

DATED: January 23, 1976.

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Consolidated Nos. 76-1316, 76-1317, 76-1318, 76-2058 and 76-2059.

SUNDSTRAND CORPORATION,

Plaintiff-Appellee,

v.

SUN CHEMICAL CORPORATION, RAYMOND F. RYAN, THOMAS B. HART, JR., and HENRY W. MEERS,

Defendants-Appellants.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division
No. 69 C 1660—Bernard M. Decker, Judge.

OPINION

February 23, 1977

Before FAIRCHILD, *Chief Judge,* SWYGERT and CUMMINGS, *Circuit Judges.*

CUMMINGS, *Circuit Judge.* These five appeals were consolidated and heard together. They arise out of an action brought by Sundstrand Corporation to secure redress for alleged violations of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j) and SEC Rule 10b-5 (17 C.F.R. § 240.10b-5) by Standard Kollsman Industries,

Inc. (SKI),[1] John B. Huarisa,[2] and Henry W. Meers in connection with the transfer to Sundstrand of an option held by Huarisa to purchase stock of SKI. Sundstrand sought a rescission of the transfer or the assessment of damages against the defendants. The case was first tried without a jury from September 21 to December 8, 1971. At the close of Sundstrand's case, the district judge granted the defendants' motions to dismiss under Rule 41(b) of the Federal Rules of Civil Procedure. On Sundstrand's motion, he also dismissed Huarisa's counterclaim against Sundstrand for specific performance, where Huarisa alleged that Sundstrand failed to honor a monetary obligation due Huarisa under the stock option transfer agreement between them. We reversed both dismissals and remanded for a new trial largely because the district judge had unduly limited the scope of Sundstrand's proof. *Sundstrand Corp.* v. *Standard Kollsman Industries, Inc.*, 488 F.2d 807 (7th Cir. 1973).

Another judge tried the case without a jury from September 16 to October 8, 1975, and rendered judgment against defendants for $6,287,190 (including prejudgment interest) plus costs and dismissed Huarisa's counterclaim. The judgment was accompanied by a 76-page unreported memorandum opinion containing numerous unsegregated findings of fact and conclusions of law. We of course accept the credibility findings therein. *Brennan* v. *Midwestern United Life Ins. Co.*, 417 F.2d 147, 149 (7th Cir.

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[1] SKI was merged into Sun Chemical Corporation at the close of 1972. Consequently, the amended complaint named Sun Chemical Corporation as a defendant in lieu of SKI.

[2] Huarisa died in May 1975 during the course of this litigation. His co-executors, Thomas B. Hart, Jr. and Raymond F. Ryan, were substituted as defendants in his stead.

1969), certiorari denied, 397 U.S. 989. Appeal No. 76-1317 was brought by Sun Chemical and the co-executors of Huarisa's estate; appeal No. 76-1316 was brought by defendant Henry W. Meers; and appeal No. 76-1318 was brought by Huarisa's estate because of the dismissal of Huarisa's counterclaim. The remaining two appeals concern costs in the district court. We affirm as to liability but the damages assessed below are modified.

The district court summarized the pleadings as follows:

> "The transactions in dispute occurred on January 9, 1969, when Sundstrand, in connection with merger negotiations which were taking place between Sundstrand and SKI, transferred to Huarisa 5,686 shares of Sundstrand common stock, in exchange for the right to acquire a block of 223,190 shares of SKI common stock owned by the Burke family on which Huarisa had a right of first refusal; and on February 6, 1969, when Sundstrand paid $6,360,915 for that stock. The gravamen of Sundstrand's complaint is that Huarisa, Meers and SKI conspired to violate and did violate Rule 10b-5 by misrepresenting material facts and failing to disclose material facts about the performance and financial condition of SKI during the merger negotiations which resulted in Sundstrand's purchase of the SKI stock. Huarisa has filed a counterclaim alleging that Sundstrand is obligated to repurchase from him the 5,686 shares of Sundstrand stock transferred to him." (Mem. op. 2.)

As might be expected in litigation which is completing its eighth year, the factual setting is complex. Prior to its merger into Sun Chemical on December 31, 1972, SKI was an Illinois corporation with places of business in Melrose Park, Illinois, and other parts of the United States. Its

common stock was traded on the New York Stock Exchange, and 2,380,000 shares were outstanding during the pertinent period. SKI's financial reports to the stockholders and public usually consolidated the financial information for itself, Kollsman Instrument Corporation (KIC), and its other subsidiaries.

During the relevant period, Huarisa was chairman of the board and president of SKI. He owned 172,000 shares of its stock, which he had acquired at an average cost of $8.75 per share. He also had a right of first refusal on 223,190 shares of common stock owned by members of the family of James O. Burke, the late founder of Standard Kollsman. On January 8, 1969, he exercised that option by delivering to the Burke family his written election to purchase their shares, together with 5 per cent of the purchase price, namely, $334,785. On January 9, Sundstrand and Huarisa entered into a stock option transfer agreement which provided that Huarisa was selling the 223,190 shares of SKI stock to Sundstrand "subject to payment by Sundstrand of the unpaid balance of $6,360,915 due * * *."[3]

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[3] Huarisa could not exercise the option himself because of tax and securities problems best summarized by his brief:

> "Sundstrand was told under Section 16(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78p (b)). Huarisa's acquisition of 223,190 shares of SKI stock for $30.00 per share within six months of the 'sale' of his own 172,000 shares of SKI stock to Sundstrand for $38.25 per share in Sundstrand stock would result in a forfeiture of the short-swing 'profit' represented by the difference between $30.00 and $38.25. The tax problem concerned the risk that any cash payment by Sundstrand to Huarisa (even mere reimbursement of his outlay to acquire the Burke stock) shortly before or after an otherwise tax-free merger between SKI and Sundstrand might be deemed to be taxable 'boot' to Huarisa under Section 356 of the Internal Revenue Code (26 U.S.C. § 356)." (Br. 14 n.*)

At the same time, to reimburse Huarisa for his payment of 5 per cent of the purchase price, Sundstrand agreed to convey 5,686 shares of its common stock to him. The actual transfer of those shares to Huarisa took place on March 3. On February 6, Sundstrand paid $6,360,915 for the Burke shares through an escrowee bank. The bank delivered them to Huarisa's agent, Hart, who turned them over to Sundstrand.

The stock option transfer agreement of January 9 was preceded by merger negotiations between Sundstrand and SKI commencing in November 1968. Meers, a managing partner of the Chicago office of White, Weld & Co., underwriter of securities and merger broker for corporations, was an outside director of SKI. He served as such from May 1967 to May 1970. In late spring or early summer of 1968, Meers recommended several companies, including Sundstrand, to Huarisa as good merger prospects for SKI. In mid-November 1968, at Huarisa's direction, Meers telephoned James Ethington, Sundstrand's president, to inquire as to his present interest in a merger.[4] Meers informed Ethington of SKI's 1967 earnings of $1.30 per share and its published earnings for the first nine months of 1968. Ethington told Meers that Sundstrand would be interested in merger discussions. During the en-

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[4] "Meers learned of Sundstrand's general interest in acquisitions and of its particular interest in SKI from Sundstrand. In early 1968, Meers met Ethington during the course of White, Weld's work on a Sundstrand underwriting, and Ethington told Meers that Sundstrand was interested in acquisitions and invited Meers to bring suggestions to his attention. Then in September, 1968, an officer of United Controls discussed its interest in acquiring SKI with a White, Weld partner from Minneapolis, who promptly reported this to Meers." (Meers Opening Br. at 6.)

suing November-December 1968 merger talks, Huarisa told Sundstrand's officers that SKI's earnings for the first three quarters of 1968 were 86¢ per share, in accordance with its published nine months' earnings statement.

On the afternoon of December 26, 1968, Ethington and Louis H. Schuette, vice chairman of Sundstrand, met with Meers to negotiate a price for Sundstrand's proposed acquisition of SKI. Meers was acting as an agent for Huarisa at the meeting and periodically called Huarisa about the price terms. After three hours of bargaining, Ethington and Schuette offered $38.25 per share for SKI's stock. This offer was accepted by Huarisa who agreed to submit it to his board of directors. On December 27, 1968, Ethington delivered a written proposal for Sundstrand to acquire SKI in exchange for Sundstrand's common stock at its market value, which was approximately equivalent to $38.25 for each share of SKI stock. On January 2, 1969, SKI's board of directors authorized Huarisa to proceed on the basis of Sundstrand's proposal, which was made public the same day. On January 7, officers and employees of Sundstrand began to survey SKI's operation in order to determine whether the merger should be consummated. On January 20, Sundstrand concluded to cancel the merger negotiations. The district court found that the reasons were as follows:

> "certain aspects of the SKI operation, including an increase in labor costs which a merger would cause, undesirable SKI labor practices, and lack of the expected compatibility of SKI's and Sundstrand's products, made the acquisition unattractive. The opinion was also expressed that SKI's earnings projects were somewhat optimistic [due in large part to SKI's heavy deferral of preproduction costs]." (Mem. op. 23-24.)

At a January 22 meeting with SKI officials and Meers, Sundstrand adhered to its decision to call off the merger negotiations, but Sundstrand president Ethington said that Sundstrand was going to honor "its commitment" of January 9 to Huarisa with respect to purchasing the Burke shares. The next day, the two companies announced that the merger plans had been dropped.

As already noted, on February 6, 1969, Sundstrand paid an escrowee the balance of $6,360,915 for the Burke family's 223,190 shares of SKI stock. Four days later, Sundstrand was looking for a purchaser for those shares. On March 21, Norman Alexander, president of Sun Chemical, telephoned Sundstrand president Ethington and said that Alexander had copies of adverse reports on SKI by James W. Burke, a dissatisfied SKI director, and Ernst & Ernst, his firm of certified public accountants. Ethington and Ross, secretary of Sundstrand, flew to New York the next day to read those reports which questioned as of May 1968 the propriety of SKI's continued deferral of preproduction costs and the failure to recognize losses on some of the contracts which ultimately resulted in a net loss of 15¢ per share in SKI's report for 1968 published on March 21, 1969. After learning of SKI's financial results for 1968 and of the Burke and Ernst & Ernst reports, Sundstrand again tried unsuccessfully to dispose of its SKI stock and demanded rescission in July 1969. When rescission was refused, Sundstrand filed this action on August 9, 1969. In December 1975, Sundstrand sold its SKI stock, which had been converted into Sun Chemical stock through the December 1972 merger of the two companies, for an undisclosed sum.

I. Liability Standard for Huarisa and Sun Chemical

In considering the liability of Huarisa, the district court concluded that

> "he deliberately, or, at best, recklessly, misrepresented SKI's nine months' earnings, SKI's earnings for 1968 and for 1969, the interest of other companies in acquiring SKI at a price of $45 and the amount of potential write-offs of deferred preproduction costs for 1968. Huarisa also deliberately, or recklessly, failed to disclose the existence of the Burke and Ernst & Ernst reports, the Price Waterhouse memorandum of January 27, 1969, and the need for write-offs because of losses on contracts at year-end 1968." (Mem. op. 65.) [5]

The court added that Huarisa conspired with SKI and others officers, particularly Messrs. Ryan and Werle,[6] in making these misrepresentations, and that the misrepresentations of SKI personnel made during Sundstrand's January 1969 survey of SKI and during the Sundstrand-SKI meeting on January 22 were also made intentionally or recklessly. Besides being liable as a co-conspirator, Huarisa was held liable because he was a "controlling person" of SKI within Section 20(a) of the Securities Ex-

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[5] The Price Waterhouse memorandum of January 27, 1969, stated its preliminary assessment that write-offs in the range of $3 million to $4.5 million would have to be made on the books of SKI's subsidiary, KIC, as of year-end 1968. Ultimately, adjustments of more than $4.6 million were charged on the books of that subsidiary as of year-end 1968.

[6] Ryan was SKI's financial vice president and Werle was KIC's vice president-controller. They received the January 27 Price Waterhouse memorandum on February 3 and January 31, respectively.

change Act of 1934 (15 U.S.C. § 78t(a)). His executors do not contest that he was a controlling person (Sundstrand Br. 23, n. *).

In employing the intentional or reckless test with respect to Huarisa's and other SKI employees' conduct, the district court acted correctly. In *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 195, the Supreme Court held that a private cause for damages would not lie under Section 10b and Rule 10b-5 in the absence of an intent to deceive or manipulate on the defendant's part. Sundstrand's amended complaint alleged both fraud and deceit, and the intent standard of *Hochfelder* was employed by the court below in passing on Huarisa's liability. It is true that in *Hochfelder* the Supreme Court did not decide whether reckless behavior is sufficient for civil liability under Section 10b and Rule 10b-5, although it recognized that recklessness is sometimes considered a form of intentional conduct for purposes of imposing liability for some acts. 425 U.S. at 194, n. 12. Subsequently we held a corporation liable under Rule 10b-5 where, "blinded by conflict of interest," it "wantonly ignored" readily available evidence of the unfairness of a proposed acquisition and therefore failed to disclose certain facts to the other stockholders of the company it controlled and proposed to sell. *Bailey* v. *Meister Brau, Inc.,* 535 F.2d 982, 993-994 (7th Cir. 1976). This was akin to the alternative reckless standard employed by Judge Decker. See also *Lanz* v. *Drexel & Co.,* 479 F.2d 1277, 1306 (2d Cir. 1973) (*en banc*); cf. *Bonner* v. *Coughlin,* 545 F.2d 565, 567-569 (7th Cir. 1976) (*en banc*); *Kimbrough* v. *O'Neil,* 545 F.2d 1059, 1061 (7th Cir. 1976) (*en banc*). Therefore, there was no error in using the "reckless" alternative in assessing Huarisa's liability, as his counsel seems to concede.

Sun Chemical does not contest that it is liable as the successor to SKI if Huarisa, Ryan, Werle and other SKI personnel violated Rule 10b-5, as the court found.

To escape liability, Huarisa and Sun Chemical assert that Sundstrand is barred from recovery by its failure to exercise due care or diligence. However, that defense is not available in an intentional fraud case. *Holdsworth* v. *Strong,* 545 F.2d 687 (10th Cir. 1976) (*en banc*). As will be seen, Sundstrand has amply shown reliance on Huarisa's and SKI's misrepresentations and omissions when entering into the January 9 agreement, and that its reliance was then justified. Under *Holdsworth,* that is sufficient to establish a causal connection between the misrepresentations and omissions and Sundstrand's injury. Therefore, the judgment below is affirmed insofar as it imposes liability on Huarisa and Sun Chemical for causing Sundstrand to enter into the stock option transfer agreement of January 9.

A. Misrepresentations and Failures to Disclose by Huarisa and SKI

For Huarisa and Sun Chemical to be liable under Rule 10b-5, their statements must have contained material misrepresentations or they must have omitted to state material facts. The most recent test of materiality under the Securities Exchange Act of 1934 is whether "there is a substantial likelihood that a reasonable [investor] would consider [the omitted facts or misrepresentations] important in deciding" whether to invest. *TSC Industries, Inc.* v. *Northway, Inc.*, ... U.S. ....., ... 44 LW 4852, 4855; *S. D. Cohn & Co.* v. *Woolf,* ..... U.S. ....., 44 LW 3737. Applying this test, we believe the following mispresenta-

tions and omissions were material and that Sundstrand relied thereon.[7]

As to 1968, Huarisa represented to Sundstrand that SKI would earn $2.6 million or $2.9 million, and $1.16 per share, whereas it lost $367,803, or 15¢ per share. Like the court below, we remain unconvinced that these projections were reasonable because Huarisa and Ryan knew of SKI's production and financial difficulties and of the distinct possibility of large write-offs having to be made at the end of that year.[8]

The projection of $2.13 to $2.50 per share earnings for 1969 was also overstated, for the actual 1969 earnings were only 35¢ per share. Defendants have not convinced us that the 1969 projections were reasonable. Again, we agree with the district court that Huarisa and SKI knew, or were reckless in not knowing, that the 1969 earnings were grossly inflated. The pre-merger misrepresentations about SKI's earnings projections for 1968 and 1969 were continued by Huarisa and Ryan at the January 22 meeting when they endeavored to persuade Sundstrand to revoke its decision not to proceed with the merger. However, nothing said by Huarisa and Ryan on January 22 could have influenced Sundstrand to proceed with the February 6 purchase of the Burke shares, for by then Sundstrand had

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[7] Huarisa and Sun Chemical concede that if material misstatements and omissions were propagated, Sundstrand properly relied upon them in entering into the January 9, 1969, stock option agreement (Br. 45; Rep. Br. 14).

[8] The district court devoted approximately 15 pages of careful analysis to demonstrate why SKI's earnings report for the nine months ended September 30, 1968, was false and misleading. Defendants have not satisfied us that this analysis was substantially inaccurate.

received enough adverse information about SKI to call off the merger and to cause Sundstrand officers to divest themselves of the bulk of their SKI shares.

Huarisa and other SKI personnel also failed to disclose to Sundstrand that dissident SKI director James W. Burke filed a May 1968 report with the SKI board of directors questioning its accounting practices for 1967, particularly with respect to continuing to defer certain preproduction costs. Burke filed a supporting report from the accounting firm of Ernst & Ernst. These reports were discussed by the SKI's board at 25 board meetings during 1968, and representatives of Price Waterhouse, SKI's accounting firm, also discussed Burke's questions at several board meetings. Because of Burke's report, commencing in April 1968, the board received monthly financial reports showing the continual increase of deferred preproduction costs on certain SKI programs. In view of Burke's complaints to the SEC, SKI sent a Price Waterhouse partner and one of SKI's lawyers to discuss Burke's charges with the SEC, where it was concluded that the 1967 annual report did not reflect improper accounting practices. However, the Price Waterhouse firm assured the SEC that it would re-evaluate the situation when the 1968 annual report was prepared. The materiality of the nondisclosure of these reports is apparent, for SKI's board and Price Waterhouse representatives devoted major attention to them during 1968, and they certainly were a factor in causing Price Waterhouse to insist that SKI could not continue to defer preproduction costs in 1968. As a reviewing court, we are bound by the district judge's credibility determination that Sundstrand's president Ethington was influenced by the nondisclosure of these critical reports. This was supported by his and Sundstrand's secretary's March 22 flight to

New York just after the president of Sun Chemical informed them of the reports.[9]

On January 27, 1969, Price Waterhouse completed a memorandum stating its preliminary assessment that write-offs ranging from $3 million to $4.5 million would have to be made on the books of KIC for the year 1968. KIC's vice president-controller Werle admittedly received a copy of this report on January 31, and SKI's financial vice president and treasurer Ryan admittedly received it on February 3. The district court found that Huarisa also must have known of this Price Waterhouse assessment before February 6 when Sundstrand paid the $6,360,915 balance for the 223,190 Burke shares of SKI stock. This memorandum was obviously material, for it resulted in $4.6 million being charged on the KIC books in 1968, causing SKI to lose 15¢ per share. The memorandum should have been disclosed to Sundstrand, for it contradicted previous representations made by SKI personnel and certainly would have affected any reasonable investor's decision to proceed with a purchase of the magnitude involved on February 6.[10] But having been prepared so late, it of course

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[9] Although the district judge stated in an earlier portion of his opinion that it was unnecessary to resolve any conflict between the testimony of Ethington and of Huarisa and one of SKI's lawyers with respect to disclosure of the Burke and Ernst & Ernst reports (mem. op. 35), he finally concluded that Huarisa had failed to disclose the existence of the Burke and Ernst & Ernst reports (mem. op. 65).

[10] In its opinion, the district court also found that Huarisa and SKI made other false and misleading statements pertaining to the profitability of KIC's Avionics Division and to writeoffs which were in fact made at the end of 1968 (mem. op. 8, 17, 20 and 55-60). We will not discuss these matters in view of the more significant misrepresentations and omissions already discussed.

could not have influenced Sundstrand to execute or reject the January 9 stock option transfer agreement. Its nondisclosure did not motivate Sundstrand in making its February 6 payment for the Burke shares because we find Sundstrand had sufficient adverse information by then as to SKI.

Thus a number of material misstatements and omissions were made by Huarisa and SKI upon which Sundstrand relied. Whether or not this reliance was justified for purposes of damage causation, we defer to a later discussion in this opinion. However, in order to assess damage causation intelligently, it is necessary to study Sundstrand's obligation to purchase the Burke stock in greater detail.

B. Obligation of Sundstrand to Purchase Burke Stock

In the court below, Sundstrand contended that it purchased the Burke family stock on January 9 and was obligated by its written agreement of that date with Huarisa to complete the payment therefor. We agree with the district court that the January 9 agreement between Sundstrand and Huarisa did not obligate Sundstrand to complete the purchase of Burke stock. Paragraph 2 of that agreement did require Sundstrand to convey 5,686 shares of Sundstrand stock to Huarisa to reimburse him for the $334,785 which he had paid the Burkes when he exercised his option to purchase their stock at $30 per share on January 8. In order to determine Sundstrand's liability under the January 9 contract, it is necessary to consider also the December 7, 1968, Burke family's written offer to sell 223,190 common shares of SKI stock to Huarisa at $30 per share and the pooling agreement referred to therein. The pooling agreement between the Burke family and Huarisa was

dated February 23, 1967. It and the offer to sell gave John B. Huarisa the right of first refusal to purchase the Burke shares for 30 days after December 10, 1968,[11] by paying the Burkes $334,785 (5 per cent of the complete purchase price) at the time of his election to purchase. This deadline was January 9, and Huarisa satisfied this clause on January 8, 1969. Under the pooling agreement, if he wished to complete the purchase, he had until February 9 to pay an additional 20 per cent and until April 9 to pay the final 75 percent. The pooling agreement provided that Huarisa would forfeit his right to purchase the 223,190 shares of SKI in the hands of the Burke family if he failed to make any payment when due, with any prior payment being forfeited as liquidated damages. Since the agreement of January 9 between Sundstrand and Huarisa did not bind Sundstrand to pay the unpaid balance of $6,360,915, the agreement remained an offer to sell until Sundstrand should elect to purchase all the shares. Consequently, if Sundstrand did not choose to make additional payments on February 9, it would forfeit only the 5,686 Sundstrand shares that it agreed to convey to Huarisa to reimburse him for his initial payment of $334,785 (which was 5 per cent of the purchase price specified in the offer to sell and the pooling agreement). In *Sundstrand I* we characterized this transaction as follows:

> "Taking this cue [that otherwise Sun Chemical would purchase the Burke shares and thus impede any SKI-Sundstrand merger], Sundstrand expressed a willingness to purchase Huarisa's rights to the Burke stock and to issue shares in Sundstrand to reimburse Huarisa for his payment of funds due the Burkes within three days. Huarisa accepted this

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[11] The offer to sell was received by Huarisa on December 10, and the 30-day option ran from that date.

offer. On January 8, he paid the Burkes sufficient funds to hold open his right of first refusal, and executed an agreement with Sundstrand the next day, conveying his purchase rights in return for reimbursement of the [$334,785] monies paid the Burkes.

"On February 6, 1969, more than two weeks after it had rejected the possibility of merger with SKI, Sundstrand paid the Burkes $6,360,915 and received the stock of SKI which Sun Chemical had earlier offered to purchase. Huarisa was repaid [the $334,785] on March 3, when Sundstrand transferred to him 5,686 shares of its common stock. By its agreement with Huarisa, Sundstrand was to repurchase the shares from him upon fifteen days' notice at any time within two years of the contract date." (488 F.2d at 810.)

As Sundstrand has explained (Br. 15-16) and as the district court found (mem. op. 19), its reason for entering into the January 9 agreement with Huarisa was to prevent Sun Chemical from acquiring a block of SKI stock large enough to frustrate the proposed Sundstrand-SKI merger before Sundstrand could complete its study of SKI which commenced on January 7 and ended on January 20. Previously Sundstrand had been erroneously told by its counsel that the agreement of January 9 obligated it to buy the 223,190 shares, and accordingly it proceeded with the purchase on February 6. As a result, although Sundstrand's president told Huarisa on January 6 that Sundstrand would only be interested in buying the Burke stock if the proposed merger with SKI were to take place, on January 22, after the merger negotiations terminated, he told Huarisa that Sundstrand would honor "its commitment" of January 9 with respect to the Burke shares.

II. Liability of Meers

Finally, we must consider whether Meers is also liable under Rule 10b-5 for the injury suffered by Sundstrand. The district court held him liable for three independent reasons: (1) failure to disclose the Burke and Ernst & Ernst report even though he had a duty to do so; (2) as an aider and abettor of Huarisa and SKI; and (3) as a "controlling person" of SKI under Section 20(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78t (a)). We reach only the first ground.

Nondisclosure of the Burke and Ernst & Ernst Reports

A. Duty to Disclose

As the district court phrased it, Meers was "on both sides and in the middle of the transaction" (mem. op. at 68). Meers was an SKI director and was also acting as a merger broker for SKI and Huarisa with respect to Sundstrand. His firm was to receive a $150,000 fee if the merger with Sundstrand was completed. In the past, his firm had performed investment banking services for Sundstrand and its officials had confidence in him.[12]

Thus, although he was acting in a nominally adversary relationship vis-á-vis Sundstrand as SKI's merger broker, Sundstrand could properly rely on its pre-existing and contemporaneous banker-client relationship with

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[12] In 1968, Meers' investment banking firm, White, Weld & Company, served as co-managing underwriter of a public offering by Sundstrand with Meers personally performing services in connection with the offering. Farwell Smith, a partner in White, Weld, worked under Meers on this underwriting and continued thereafter to make regular business calls on Sundstrand until March 1969 when the revelation of the existence of the Burke and Ernst & Ernst reports terminated the relationship.

Meers for fair disclosure. In this posture as a quasi-fiduciary with respect to Sundstrand, Meers had an affirmative common law duty to disclose material facts relating to the proposed merger.[13] Haimoff, *Holmes Looks at Hochfelder and 10b-5*, 32 Bus. Law 147, 164-173 (1976) [hereinafter cited as Haimoff] and authorities cited therein. The district court therefore properly held that Meers had a duty to disclose the Burke and Ernst & Ernst reports during his pre-January 9 discussions with Sundstrand. See *Carr* v. *New York Stock Exchange*, 414 F.Supp. 1292, 1299-1300 (N.D. Calif. 1976); cf. Jennings, *Insider Trading in Corporate Securities*, 62 Nw. U. L. Rev. 809, 818 (1968).

B. Meers' Culpbaility in Omitting the Material Facts

After *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 183, a merely negligent breach of a duty defendant owes plaintiff is not sufficient to trigger liability under Section 10b of the Securities Exchange Act of 1934 as implemented by Rule 10b-5. The opinion below, authored without the benefit of *Hochfelder*, did not make a finding on whether Meers acted with *scienter* or recklessly in failing to disclose the Burke and Ernst & Ernst reports because under pre-*Hochfelder* law in this Circuit the breach of an affirmative duty was actionable without more. *Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364, 368 (7th Cir. 1974), certiorari denied, 419 U.S. 875. Under a negligence Rule 10b-5 standard, a description of the character of the conscious attention the defendant gave his breach of duty was wholly unnecessary. Therefore, unless we can conclude that the level of conscious attention Meers gave to the breach of his duty meets as a matter of law the *scienter* requirement of *Hochfelder*, or the reckless re-

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[13] In contrast, Ernst & Ernst did not owe a common law duty to the plaintiffs in *Hochfelder*, 425 U.S. at 192 n. 9.

quirement of other cases, we would have to remand for a factual finding on this issue.[14] Since we find recklessness present, there is no need for a remand.

As noted above in our discussion of Huarisa's and Sun Chemical's liability, *Bailey* v. *Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976), resolved for this Circuit the ambiguity in footnote 12 of *Hochfelder* in favor of including reckless behavior in the definition of what behavior is necessary to maintain a Rule 10b-5 action. However, Meers' conduct comprised reckless nondisclosure rather than disclosing information with a reckless disregard for the truth of the material asserted. Thus a more extended analysis of the reckless behavior standard is required in our discussion of Meers' liability.[15]

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[14] Cf. *TSC Industries, Inc.* v. *Northway, Inc.* ..... U.S. ....., ..., 44 LW 4852, 4855:

> "Only if the established omissions are 'so obviously important to an investor that reasonable minds cannot differ on the question of materiality' is the ultimate issue of the materiality appropriately resolved 'as a matter of law' by summary judgment."

[15] Rule 10b-5 actions have proved to be an idiosyncratic element of the law since in these cases the difficult problems presented have been in the formulation of the governing principles of law rather than the more common legal problem of application of settled principles of law to particular facts. Haimoff, *supra*, at 147. Indeed *Hochfelder* itself left open, in addition to the reckless behavior question, whether aiding and abetting was a proper Rule 10b-5 theory, and if so what its elements were, as well as whether *scienter* was required in a Rule 10b-5 injunctive proceeding brought by the SEC. 425 U.S. at 191 n. 7 and 194 n. 12.

Therefore, we will only reach the reckless nondisclosure question in this case since the other two theories of liability discussed below—aiding and abetting and control person—would require us to face the difficult task of defining the elements of these theories after *Hochfelder*. We leave this task to another day.

At common law reckless behavior was sufficient to support causes of action sounding in fraud or deceit. Since there is no hint in *Hochfelder* that the Court intended a radical departure from accepted Rule 10b-5 principles,[16] it would be highly inappropriate to construe the Rule 10b-5 remedy to be more restrictive in substantive scope than its common law analogs.[17] *McLean* v. *Alexander*, 420 F.Supp. 1057, 1080-1082 (D. Del. 1976). See generally, Haimoff, *supra*, at 154-156. Therefore, we hold that a reckless omission of material facts upon which the plaintiff put justifiable reliance in connection with a sale or purchase of securities is actionable under Section 10(b) as fleshed out by Rule 10b-5. See *Coleco Industries, Inc.* v. *Berman*, 423 F.Supp. 275 (E.D. Penn. 1976); *SEC* v. *Bausch & Lomb, Inc.*, 420 F.Supp. 1226, 1242-1244 n. 4 (S.D.N.Y. 1976).

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[16] While three Circuits held that negligence could support Rule 10b-5 actions before *Hochfelder*, there has not been any inter-Circuit controversy that *scienter* short of specific intent to defraud is sufficient to support liability. *McLean* v. *Alexander*, 420 F. Supp. 1057, 1081 n. 123 (D. Del. 1976).

[17] After setting forth the legislative history of Section 10(b) which indicated that Congress intended a good faith defense to 10(b) liability, the Court in *Hochfelder* stated:

> "there is no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith. The catchall provisions of § 10(b) should be interpreted no more broadly." 425 U.S. at 206.

But by the same token, there is no justification for construing 10(b) more narrowly in light of the fact that good faith is not appropriate as a defense to reckless or intentional behavior. *McLean* v. *Alexander*, 420 F.Supp. at 1081.

Apparently the only post-*Hochfelder* reported definition of recklessness in the context of omissions appears in *Franke* v. *Midwestern Oklahoma Development Authority*, CCH Fed. Sec. L. Rep. ¶ 95,786 at 90,850 (W.D. Okl. 1976):

> "reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."

As the Supreme Court conceded in *Hochfelder:*

> "In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liabilitly for some act." 425 U.S. at 193-194 n. 12.

The *Franke* definition of recklessness is "the kind of recklessness that is equivalent to wilful fraud." *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J. concurring) (*en banc*), certiorari denied *sub nom. Coates* v. *SEC*, 394 U.S. 976.[18]

Indeed, the *Franke* definition of recklessness should be viewed as the functional equivalent of intent. Cf. Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U. L. Rev. 562, 570-571 (1972). Under this definition, the danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing,[19] and the omission must derive from something more egregious

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[18] As Judge Friendly has succinctly stated, "[s]ilence when there is a duty to speak can itself be fraud." 401 F.2d 833, 865.

[19] This is an objective test although the circumstances must be viewed in their contemporaneous configuration rather than in the blazing light of hindsight.

than even "white heart/empty head" good faith.[20] While this definition might not be the conceptual equivalent of intent as a matter of general philosophy, it does serve as a proper legally functional equivalent for intent, because it measures conduct against an external standard which, under the circumstances of a given case, results in the conclusion that the reckless man should bear the risk of his omission.[21] See O. Holmes, The Common Law 130-163; Haimoff, *supra*; *passim;* Ruder, Texas Gulf Sulphur—*The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases,* 63 Nw. U. L. Rev. 423, 436-437, 441-442, 444 n. 107 (1968). See also *Lanza* v. *Drexel & Co.,* 479 F.2d 1277, 1306 n. 98 (2d Cir. 1973) (*en banc*); *Rochez Bros., Inc.* v. *Rhoades,* 491 F.2d 402, 407-408 (3d Cir. 1974). When measured against this external standard, it may be said that such a reckless man has "use[d] or employ[ed] [a] deceptive device" within Section 10(b).[22]

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[20] This is a subjective test with the requirement of something more than "inexcusable negligence" imposed because of *Hochfelder,* 425 U.S. at 190 n. 5. Thus if a trial judge found, for example, that a defendant genuinely forgot to disclose information or that it never came to his mind, etc., this prong of the *Franke* test would defeat a finding of recklessness even though the proverbial "reasonable man" would never have forgotten.

[21] Moreover, we note this standard of reckless behavior will not significantly broaden the class of plaintiffs who may seek to impose liability upon experts who perform services or express opinions with regard to matters under the Securities Exchange Act of 1934. Cf. *Hochfelder,* 425 U.S. at 214 n. 33.

[22] See Note, The Supreme Court, 1975 Term, 90 Harv. L. Rev. 56, 255-260.

Application of the Recklessness Standard to Meers' Conduct

1. The Objective Element

At the December 26 merger negotiation meeting, Meers agreed with Ethington that Ethington's earnings estimates for SKI of $1.16 per share in 1968 and $2.00[23] per share in 1969 were reasonable. Although there is conflicting evidence on whether Meers confirmed these earnings figures as reasonable, we cannot say that the trial court's credibility determination in Ethington's favor was clearly erroneous.[24] Since Sundstrand was primarily concerned that the proposed merger not result in an earnings dilution, the reliability of SKI's earnings projections was, of course, most important to Sundstrand and, as the district court realized (mem. op. 12), it stretches credulity to believe that SKI's earnings were not discussed. Given the

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[23] This figure was discounted by Ethington's skepticism from Huarisa's more optimistic representations of $2.13 to $2.41 for 1969.

[24] Meers testified that there was no discussion of projected earnings for either 1968 or 1969. Ethington claimed Meers confirmed the reasonableness of the figures Huarisa had given Ethington after Ethington told Meers what Huarisa's estimates were. Schuette's testimony—his deposition in his absence at trial—is neutral on whether Meers confirmed the figures as being reasonable. However, Schuette's testimony does demonstrate the importance of the earnings figure in Sundstrand's merger proposal. (Schuette Dep. 101-111.) Contrary to Meers' counsel's protestations, Ethington's deposition does not impeach, but rather strongly affirms, the conclusion that Meers passed on the reasonableness of the 1969 earnings projections in the December 26 meeting. (Ethington Dep. 31-44.) At best, the Ethington deposition is simply silent on whether the 1968 earnings estimate was discussed.

importance of the earnings projection, the danger of misleading Sundstrand (as of December 26, 1968) was high when information—the Burke and Ernst & Ernst reports—that the earnings estimates might be significantly overstated due to accounting gimmickry was kept from Sundstrand's officers.

Meers denies actual knowledge of the danger, and the trial court made no determination that Meers possessed actual knowledge. However, a finding on the objective obviousness of the danger was made (mem. op. 32-34), which is sufficient for liability even absent an actual appreciation by Meers of the signifiance of the omitted material to Sundstrand.

The factual findings of the district court relevant to the obviousness of the danger, which upon our independent examination of the record we find amply supported, are most succinctly stated in the trial court's own words (mem. op. 32-34):

> "[Meers] failed to disclose to Sundstrand that James W. Burke, a director, officer and large shareholder of SKI had, in May, 1968 formally submitted to the board of directors of SKI questions as to the propriety of certain SKI accounting practices, including that of continuing to defer certain preproduction costs on the CPU-46 and other programs. The questions related principally to accounting practices as revealed in the 1967 annual report. Burke supported his questions in June with a report from Ernst & Ernst, an independent firm of certified public accountants which Burke had asked to consider the propriety of the practices he challenged. Ernst & Ernst, though declining to render a formal opinion because it had not conducted an examination in conformity with generally accepted auditing procedures, concluded that the practices addressed in the Burke Report seemed questionable.

"These reports were considered serious enough by the SKI board of directors to be discussed at at least twenty-five board meetings during the spring and summer of 1968. The board directed the officers of SKI to prepare responses to Burke's questions, and at Meers' request, representatives of Price Waterhouse, the firm of certified public accountants which prepared the SKI 1967 annual report, appeared at several of these meetings to discuss Burke's questions. The board eventually decided that Burke's criticisms were without merit. However, as a result of Burke's questions, the board began, in April, 1968, to receive monthly financial reports. These reports revealed the continual increase of deferred preproduction costs on the CPU-46 and other programs throughout 1968. Meers was concerned enough to ask about the progress of each of the contracts on which costs were deferred, including the CPU-46, at every board meeting and asked particularly whether the CPU-46 had been qualified with the government—a step which was essential to producing an acceptable product and obtaining follow-on contracts. In each such meeting he learned that no such qualification had been obtained. (In fact, qualification was not obtained until September, 1969.)

"Dissatisfied with the board's action, Burke complained to the SEC. Ryan, Hart, acting as attorney for SKI, and H. Dudley Murphy, a partner of Price Waterhouse, met in Washington with Curtis A. Davies of the SEC to discuss Burke's charges. At that meeting it was concluded that the 1967 annual report did not reflect improper accounting practices. With respect to preproduction costs on the CPU-46, Murphy assured Davies that Price Waterhouse would reevaluate the situation when they prepared the 1968 annual report. This assurance was reiterated in a letter from Murphy to Davies. Both Ryan and Meers saw copies of that letter. None of this was disclosed to Sundstrand.

> "Neither was it disclosed that, because of questions about the propriety of SKI's 1967 financial statements, two directors of SKI, Burke and Perry Addleman, refused to sign a registration statement filed by SKI with the Securities and Exchange Commission in March, 1968. Meers later suggested that the registration statement be withdrawn, which was done in August, 1968. In addition, defendants failed to disclose to Sundstrand that Addleman also raised questions about the financial accounting of SKI."

The trial court concluded that "the materiality of the Burke and Ernst & Ernst reports is not open to serious question" (mem. op. 36).

Meers places heavy reliance on the SEC meeting of August 1968 as dispelling the doubts the Burke and Ernst & Ernst reports had raised in his mind. However, the 1968 accounting practices were not passed on in the SEC meeting. The monthly financial reports which Meers requested as a result of Burke's initial complaints continued to show an increase in deferred preproduction costs. At every board meeting Meers asked about the preproduction costs. Indeed, Meers found out that the computer unit CPU-46 had still not been qualified with the government, a condition precedent for additional government contracts for that product. Thus the principal expected source of revenue against which to amortize the mounting preproduction costs remained indefinite and unreliable. Under these circumstances, any reasonable man would be bound to know that the danger posed to Sundstrand by the serious conflict on SKI's accounting policy among its board members and two public accounting firms as to deferred preproduction costs had not been vitiated by the inconclusive August 1968 SEC meeting.

2. *The Subjective Standard*

Yet even if constructive knowledge of the danger to Sundstrand of omitting certain facts is imputed to Meers, an omission caused because Meers genuinely forgot about these facts would not be actionable, even if such an omission derived from inexcusable neglect. Cf. *SEC* v. *Bausch & Lomb,* 420 F.Supp. 1226, 1241-1244, n.n. 3 & 4 (S.D.N.Y. 1976). But we need not remand for a factual determination here since a subsequent pre-January 9 event removed Meers' omission from the putative realm of mere inexcusable neglect. At the January 2, 1969, board meeting to approve the Sundstrand merger proposal, in Meers' presence Burke asked if Sundstrand had been told of the Burke and Ernst & Ernst reports and Huarisa replied that it had not. Therefore, rather than putting the question out of his mind, Meers must have consciously decided not to disclose (and did not disclose) [25] the substance of the reports to Sundstrand.[26] Thus recklessness is estab-

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[25] Meers claims that Sundstrand had been informed of the Burke and Ernst & Ernst reports on January 6, 1969. On this (as on most of the important factual elements of this case) there is a dispute in testimony. The trial judge resolved the dispute as follows:

> "Thus, even if the defendants' witnesses are believed, any disclosure of the Burke and Ernst & Ernst reports on January 6, 1969, was made in a false and misleading manner and did not inform Sundstrand of the material facts" (mem. op. at 35-36).

Cf. note 9 *supra.*

[26] The board meeting took place at noon on January 2, 1969. In the morning, Ethington called Meers and inquired if he knew how a leak to the New York Stock Exchange about the proposed merger, causing the suspension of trading of SKI stock, had gotten out. Meers replied he did not know. Despite this recent contact with Ethington, Meers made no attempt to inform him of the Burke and Ernst & Ernst reports after the noon board meeting made clear that Sundstrand did not know of the reports' existence. (Tr. 124-125, 250, 646-649, 2206-2210.)

lished as a matter of law by the facts found by the trial court. *Bailey* v. *Meister Brau, Inc.*, 535 F.2d 982, 993-994 (7th Cir. 1976).

C. Remaining Elements of the Cause of Action

Since the omitted facts pass the stringent objective element of the recklessness test, the district court's determination of the materiality of the Burke and Ernst & Ernst reports—that there is a substantial likelihood they would be considered important by a reasonable investor—is not open to argument, especially since materiality assessments are peculiarly for the trial court as fact-finder.[27] *TSC Industries, Inc.* v. *Northway, Inc.*, ... U.S. ....., ..., 44 LW 4852, 4855.[28] With materiality established, reliance

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[27] The legal character of the materiality concept has been recently explained by the Supreme Court:

> "The issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts. In considering whether summary judgment on the issue is appropriate, we must bear in mind that the underlying objective facts, which will often be free from dispute, are merely the starting point for the ultimate determination of materiality. The determination requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact." *TSC Industries, Inc.* v. *Northway, Inc.* ..... U.S. ....., ..., 44 LW 4852, 4855 footnotes omitted).

[28] In this case, the alternative definition of materiality drawn in *Northway* is perhaps a more useful guide:

> "Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." ..... U.S. at ....., 44 LW at 4855 (footnote omitted).

in an omissions case is presumed. *Affiliated Utes Citizens* v. *United States*, 406 U.S. 128.[29]

Of course, Sundstrand would be open to a defense of non-reliance on the omissions if Meers could meet the burden of proof running against him to establish such an affirmative defense. *McLean* v. *Alexander*, 420 F.Supp. 1057, 1077-1079 (D. Del. 1976). Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 Harv. L. Rev. 584, 606 (1975); Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 Nw. U. L. Rev. 561 (1975); Note, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 Colum. L. Rev. 562, 567 (1972). In a non-disclosure case, reliance is vitiated if the plaintiff is chargeable with the omitted information. Under a negligence standard of liability, plaintiff could not justifiably claim reliance if he had not exercised due diligence. Wheeler, *supra*. But under a reckless or *Hochfelder scienter* standard, "[i]f contributory fault of plaintiff is to cancel out wanton or intentional fraud, it ought to be gross conduct somewhat comparable to that of defendants." *Holdsworth* v. *Strong*, 545 F.2d 687, 693 (10th Cir. 1976); cf. *McLean* v. *Alexander*, 420 F.Supp. 1057, 1078 (D. Del. 1976).

We find nothing in the record that remotely suggests that Sundstrand was recklessly remiss in not ferreting out on its own the information contained in the Burke and Ernst & Ernst reports before its down payment to

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[29] As an objective indicium of Sundstrand's reliance on the "non-existence" as it were of the Burke and Ernst & Ernst reports, it should be recalled that Ethington and Ross rushed to Sun Chemical in New York in late March 1969 after learning Sun held copies of the reports. After digesting the reports, Ethington immediately berated Meers on his failure to disclose. (Mem. op. at 27, 35.)

Huarisa on January 9, 1969 (mem. op. at 60-61). Rather, the record clearly suggests that if Meers had disclosed the reports, Sundstrand would not have executed the January 9 stock option transfer agreement with Huarisa which compelled it to transfer 5,686 of its shares to Huarisa in return for receiving his option to buy the Burke shares.[30]

Nor can Meers insulate himself from this liability by urging that he was only involved in the SKI-Sundstrand merger, for it is clear that the January 9 agreement was an integral part in any such merger by preventing Sun Chemical from purchasing the Burke shares "for another thirty days" (mem. op. 17-18), *i.e.*, until Febuary 9. Since Meers' conduct was partly responsible for Sundstrand's signing the stock option transfer agreement,[31] his nondisclosure was sufficiently "in connection with the purchase or sale of any security," as required by Rule 10b-5. *Eason* v. *General Motors Acceptance Corp.*, 490 F. 2d 654 (7th Cir. 1973), certiorari denied, 416 U.S. 960; *Heit* v. *Weitzen*, 462 F.2d 909, 912 (2d Cir. 1968), certiorari denied, 395 U.S. 903.

It follows that Meers must share in the Huarisa estate's and Sun Chemical's liability on a material omission Rule

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[30] In hindsight, the reports may not have told more than Sundstrand already knew from its investigation of SKI. But the full Sundstrand investigative team did not compile its overall findings until January 20, 1969. And no subset of the team even preliminarily discussed findings until January 10. Thus in any event the omitted reports held substantial adverse information which was unknown to Sundstrand as of the stock option purchase on January 9.

[31] Meers, although not present at the meeting where Sundstrand signed the agreement to purchase Huarisa's option on the Burke stock, was aware that Huarisa had a right of first refusal which had been triggered by Sun Chemical's offer for the Burke stock. Moreover, the trial court found that Meers had actual knowledge of Sundstrand's prospective purchase of the Burke stock prior to January 9 (mem. op. 15-16).

10b-5 theory. Therefore, we need not decide whether Meers would also be liable as an aider and abettor [32] or as a "controlling person" of SKI under 15 U.S.C. § 78t (a)—the alternative grounds purportedly establishing Meers' liability in the opinion below.

III. Damage Causation for Purchase of SKI Stock on February 6

When the January 9 agreement was made between Sundstrand and Huarisa as to the Burke stock option, Huarisa's and SKI's intentional or reckless misrepresentations and omissions and Meers' reckless omissions had convinced Sundstrand that it should seriously consider merging with SKI. A prerequisite of the merger, *viz.*, keeping the huge block of Burke stock out of Sun Chemical's hands, prompted Sundstrand to execute the agreement. However, as seen, that agreement only required Sundstrand to transfer 5,686 of its shares to Huarisa, which was accomplished on March 3. Sundstrand was not bound by the January 9 agreement to buy the Burke shares by paying the $6,360,915 balance on February 6 or later.[33] The record shows

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[32] This question was left open in *Hochfelder*, 425 U.S. at 191-192 n. 7. But compare *Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir. 1974), certiorari denied, 419 U.S. 875, with *Franke* v. *Midwestern Oklahoma Development Authority*, CCH Fed. Sec. L. Rep. ¶ 95, 786 at 90, 850 (W.D. Okl. 1976). See also Note, Hochfelder v. Ernst & Ernst—*A Troublesome New Standard for Aiding and Abetting a Rule 10b-5 Violation*, 1 J. of Corp. L. 180 (1975).

[33] The entire amount was paid on February 6, although the next installment payment was not due until February 9, because Sundstrand wanted to keep the matter as secret as possible from Sun Chemical and the Burke family to prevent subsequent litigation challenging a *de facto* assignment by Huarisa of his option right (Pitte Dep. 172-174).

that the only reason Sundstrand completed the purchase was because its counsel mistakenly told Ethington there was a legal obligation to do so.

We cannot accept the district judge's *sua sponte* suggestion that Sundstrand completed the transaction for investment purposes. During the January 7-20 survey period, Sundstrand had learned about SKI's faulty huge preproduction cost accounting. Its president, Ethington, had sold his 2000 shares of SKI stock on January 14 and its executive vice president, Sadler, sold 1000 shares on January 17.[34] The merger was called off on January 20 and Sundstrand tried to dispose of the Burke stock commencing February 10, thus belying any investment purpose. Sundstrand had been advised that such an investment would have been an improper use of corporate funds. The market price on February 7 was $5 less than the $30 per share Sundstrand paid for the Burke shares. Sundstrand would certainly not have paid a premium over market of some $1,000,000 if this purchase was an investment in SKI stock. Finally, being unregistered and therefore restricted, the Burke stock could only be sold by Sundstrand at a substantial discount below market. For these reasons, the investment theory advanced by Sundstrand for the first time in this Court simply will not wash. Our independent study of the record shows that the principal reason Sundstrand proceeded to purchase the Burke stock on February 6 was because counsel had wrongly advised Sundstrand officials that it was legally obligated to do

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[34] Sadler sold his remaining 600 shares on February 13.

so under the January 9 agreement with Huarisa.[35] Also Sundstrand had learned enough to apprise it that forfeiture of its down payment was better than further payments under that agreement.

While Rule 10b-5 imposes "no obligation to pull back from a commitment previously made by the buyer and accepted by the seller because of after-acquired knowledge," it is true that for the purchase of damage assessment, "the time of a 'purchase or sale' of securities within the meaning of Rule 10b-5 is to be determined as the time when the parties to the transaction are committed to one another." *Radiation Dynamics, Inc.* v. *Goldmuntz*, 464 F.2d 876, 891 (2d Cir. 1972).[36] Much as in antitrust law, the ultimate goal of securities regulation is to achieve fundamental fairness in the marketplace. For antitrust, the prime aim is to avoid anticompetitive actions, while in securities law the focus is on controlling practices which

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[35] See Tr. 131, 165-167, 484-487, 625-631, 1703-1705, 2022-2023, 2420-2423, 2516-2519, 2620-2622, 2624-2627, 2635-2638 and the following depositions: Ethington 559, 565-571, 573-574, Olson 34-38, 40, 68-69, Huarisa 229-230, Pitte 96-97, 116-117, 167-168, 171-173, 180-181 and Schuette 304-305, 306-313. As we learned at oral argument, no formal written opinion was submitted by Sundstrand's counsel as to whether Sundstrand was or was not obligated to make further payments on February 6 (Sun-Huarisa Exhibit 52).

[36] Judge Waterman defined "commitment" in straightforward terms:

> " 'Commitment' is a simple and direct way of designating the point at which, in the classical contractual sense there was a meeting of the minds of the parties; it marks the point at which the parties obligated themselves to perform what they had agreed to perform even if the formal performance of their agreement is to be after a lapse of time." 464 F.2d at 891.

smack of fraud. Pursuing this analogy, the Supreme Court's recent statement on damage causation in antitrust can be usefully paraphrased here:

> "Plaintiffs must prove [securities law] injury, which is to say injury of the type the [securities] laws were intended to prevent and that flows from that which makes defendants' acts unlawful. The injury should reflect the [fraudulent] effect either of the violation or of [fraudulent] acts made possible by the violation. It should, in short, be 'the type of loss that the claimed violation would be likely to cause.'" *Brunswick Corp.* v. *Pueblo Bowl-O-Mat, Inc.*, ... U.S. ....., ..., 45 LW 4138, 4141.

Because the January 9 agreement was entered into due to Huarisa's and SKI's intentional or reckless misrepresentations and omissions and Meers' reckless omissions, SKI is entitled to recover only what that contract bound it to pay. As seen, that amount was $334,785. Since Sundstrand was not obligated to pay the additional $6,360,915 and did so only because of incorrect legal advice, reiterated here and in the court below, its recovery must be limited to $334,785 plus interest thereon. The incorrect legal advice, in conjunction with sufficient knowledge to show that forfeiture of its down payment was better than further payments, serves as the superseding cause which breaks the damage causation chain running to the defendants.

Sun Chemical and Huarisa contend that they are not liable even for this $334,785 because Sundstrand's obligation to pay this amount to Huarisa remained executory until March 3, 1969, when it transferred 5,686 of its shares to Huarisa pursuant to paragraph 2 of the January 9 agreement. However, Sundstrand had not learned of the Burke and Ernst & Ernst reports until March 21. In

any event, the "commitment" occurred on January 9, 1969, under *Radiation Dynamics, Inc., supra,* at 891. Therefore, we cannot agree that its March 3 transfer to Huarisa was voluntary rather than on account of material misrepresentations and omissions. Because the record supports the district judge's findings that SKI's and Huarisa's misrepresentations and omissions were intentional or reckless and because Meers' omissions were reckless, Sundstrand is entitled to prejudgment interest on a judgment for $334,785 at the rate of 6% per annum from January 9, 1969, to the date of judgment in this Court.[37]

IV. Dismissal of Huarisa's Counterclaim

The district court dismissed Huarisa's counterclaim under paragraph 4(a) of the January 9, 1969, stock option transfer agreement. Under that paragraph, Sundstrand agreed that it would purchase from Huarisa all or any part of its 5,686 shares transferred to Huarisa on March 3, 1969, for $58.75 per share on 15 days' written notice from Huarisa. He gave such notice on November 11, 1970, but Sundstrand rejected it on November 23, 1970, on the ground that Huarisa had violated the Securities Exchange Act of 1934 and SEC rules thereunder. The counterclaim sought specific performance or damages of $334,763.25 plus interest.

The reason given below for the dismissal of the counterclaim is that the agreement in question was made in violation of the Act and Rule 10b-5, so that it was void as regards the rights of Huarisa under Section 29(b) of the Act (15 U.S.C. § 78cc-(b)) (mem. op. 76). This accords

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[37] We will not consider defendants' various attacks on the amount of interest since they were not raised below.

with our opinion in *Sundstrand I* (488 F.2d at 816). The testimony of Messrs. Ethington, Schuette, Sadler and Ross was receivable under Rule 601 of the Federal Rules of Evidence and therefore not barred by the then current Illinois Dead Man's Act (Ill. Rev. Stat. 1971 ch. 51, § 2).[38]

V. Disposition

For the foregoing reasons, we affirm the judgment below as to liability. As to damages, the judgment is vacated with directions to enter judgment for plaintiff for $334,785 plus 6% interest from January 9, 1969, to date. Each party will bear its own costs on appeal. We affirm the district court's order of August 18, 1976, with respect to costs in that court.

A true Copy:

Teste:

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Clerk of the United States Court of Appeals for the Seventh Circuit

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[38] The trial court did not rely on any inadmissible evidence in its findings against Meers, nor do we. Meers' counsel has evidently abandoned its contention that portions of Sundstrand vice chairman's Schuette's deposition were inadmissible. At any rate, the point is without merit. See Rule 32(a)(3) of the Federal Rules of Civil Procedure and Rule 802 of the Federal Rules of Evidence. Indeed, in its notes to Rule 802, the Supreme Court's Advisory Committee on the Proposed Rules of Evidence expressly recognized the admissibility of depositions under Rule 32 of the Rules of Civil Procedure as a continuing independent exception to the hearsay rule, 28 U.S.C.A. Federal Rules of Evidence 573.

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

SUNDSTRAND CORPORATION,

Plaintiff-Appellee,

v.

SUN CHEMICAL CORPORATION, RAYMOND F. RYAN, THOMAS B. HART, JR., and HENRY W. MEERS,

Defendants-Appellants.

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division
Nos. 76-1316, 76-1317, 76-1318, 76-2058 and 76-2059

JUDGMENT

February 23, 1977

These causes came on to be heard on the transcript of the record from the United States District Court for the Northern District of Illinois, Eastern Division, and were argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said District Court is AFFIRMED as to liability. As to damages, the judgment is VACATED WITH DIRECTIONS. Each party is to bear its own costs on appeal. The District Court's order of August 18, 1976, with respect to costs in that court, is AFFIRMED. All the above is in accordance with the opinion of this court filed this date.

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

SUNDSTRAND CORPORATION,

Plaintiff-Appellee,

No. 76-1316 vs.

HENRY W. MEERS,

Defendant-Appellant.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

ORDER

April 18, 1977

On consideration of the petition for rehearing and suggestion for rehearing *en banc* filed in the above-entitled cause by defendant-appellant Henry W. Meers, no judge in active service has requested a vote thereon, and all judges on the original panel have voted to deny a rehearing. Accordingly,

IT IS ORDERED that the aforesaid petition for rehearing be, and the same is hereby, DENIED.*

IT IS FURTHER ORDERED that the slip opinion be modified by the insertion of the following clause after "counsel" in the 7th line of page 27:

> "(not the four lawyers who presented this lawsuit for Sundstrand)"

Judge Tone disqualified himself from consideration of this petition for rehearing.

* For additional authorities, see *Santa Fe Industries, Inc.* v. *Green,* ..... U.S. ....., ..., 45 LW 4317; Bucklo, The Supreme Court Attempts to Define Scienter Under Rule 10b-5: *Ernst & Ernst* v. *Hochfelder,* 29 Stanford L.Rev. 213 (1977).